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ABSTRACT

The nature, extent, and likely future of outsourcing in the United Kingdom was examined through an extensive literature review and interviews with small numbers of local authorities, companies, and contractors. Despite the limited data available, it appeared that outsourcing is concentrated in ancillary activities and is relatively marginal, both as a proportion of the work force and in terms of its organizational impact. Among the reasons cited for outsourcing were the following: cost, improved service, desire to focus on core business and reduce exposure, and flexibility to meet fluctuating supply and demand. The problems encountered by organizations resorting to outsourcing have stemmed from choosing outsourcing for the wrong reasons and preparing for it poorly. The following were identified as alternatives to outsourcing: changing the organization's overall shape/size; introducing more flexible work arrangements; and altering the means of structuring service provision. Special attention was paid to the best ways of planning and managing outsourcing, use of outsourcing by local governments, and effects of outsourcing on employees. It was concluded that continued pressures to reduce costs and maximize productivity will likely mean the continuation of partial and selective outsourcing, with clients becoming more sophisticated and demanding in what they expect from contractors. (Contains 98 references.) (MN)

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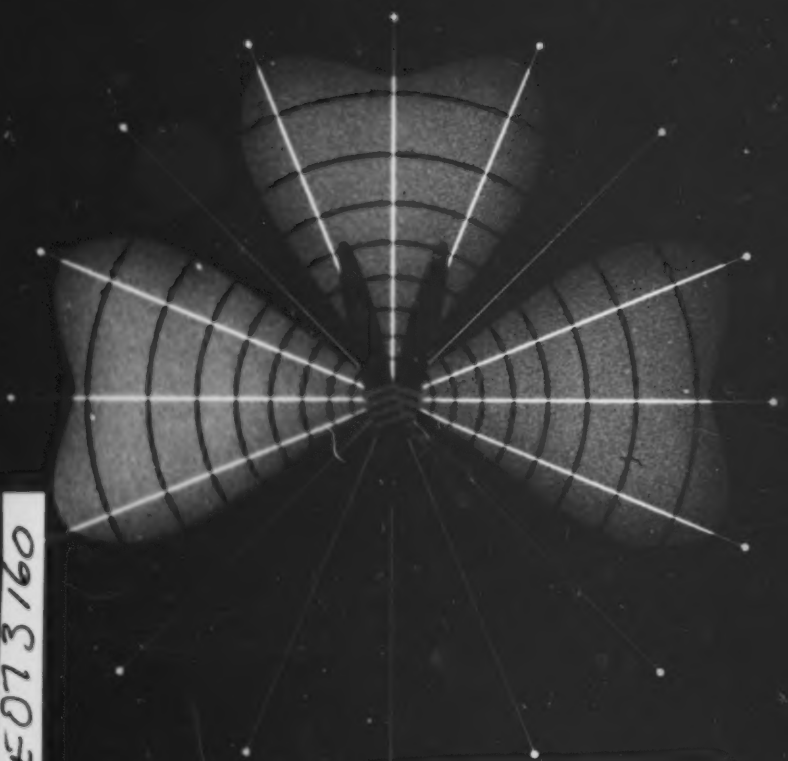

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OUTSOURCING: A FLEXIBLE OPTION FOR THE FUTURE?

Peter Reilly
Penny Tamkin

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Report 320

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1. Introduction

1.1 Why the interest?

The idea that organisations will not carry out all the activities which relate to the provision of goods and services has a long history. Adam Smith wrote over 200 years ago: *'the maxim of every prudent master is never to attempt to make at home what it will cost him more to make than to buy.'* In the nineteenth century, before the advent of the big integrated firm, outsourcing was the norm. Firms were small or loosely co-ordinated, labour supply was plentiful, and product markets fragmented and relatively stable: circumstances which allowed outsourcing to flourish. Moreover, at least in early Victorian times the recruitment and management of employees was often in the hands of 'gang masters' working under the nominal control of the owner or manager. Gradually this picture changed, as firstly resourcing became an internal responsibility, and then other activities were carried out in-house. This trend accelerated post-war as the labour market tightened and product markets became more volatile and competitive. The arrival of the mass market and volume production allowed companies to grow organically and by acquisition, until they became vertically integrated in terms of process, and self sufficient too in support functions.

Of course this did not happen everywhere. Small firms continued and latterly have grown in number. Loose holding arrangements with weak managerial systems persisted. Relevant to our study, many manufacturers continued to work on the basis of acquiring made-up parts from suppliers rather than manufacturing them themselves. The car industry is a good example of the use of sourcing from third parties. In 1989 General Motors was, for example, using 8,000 material suppliers. In other industries there has been the practice of establishing a series of subcontracts passing work from one contractor to another, as in the building industry. Of more common application is the use of

advertising or recruitment agencies to manage specific tasks on behalf of the client. Even the contracting out of service functions in the modern form has a number of examples going back over many years. For example, as long ago as 1964 the management of a whole range of tasks, from driving to catering, was given by the RAF for its early warning station in Yorkshire, to Serco.

Given this background, why of late has outsourcing become the focus of attention? Interest has been stimulated by academic debate, political encouragement and organisational imperatives.

The academic interest in outsourcing derives from consideration of the impact of economic and technological change on organisations, involving partly description and partly prescription. The central thrust of the discussion has been how companies must concentrate, if they already have not done so, on their main purpose as organisations, divesting themselves of unimportant activities. There have been various ways of describing or responding to this requirement. Peters and Waterman (1982) urged companies to *stick to their knitting*. Later Hamel and Prahalad (1990) saw the route to achieve business focus through the notion of defining and protecting *core competences*. In organisational terms, Miles and Snow (1986) described the *network organisation* where the firm would act as a kind of controlling broker focusing on what it did well, and co-ordinating the activities of third parties which might design, supply, produce and distribute to order. Robert Reich (1991) continued the same theme saying that western companies would have to focus on knowledge based activities which would form part of *enterprise webs*. In employment terms this implies making a distinction between the *core*, *peripheral* and *external* workforces (Atkinson, 1986). Each is visualised as rings of a circle moving from the central core. The *external* workforce represents the outsourced activity which together with the *peripheral* group can be adjusted in size to meet changing market demands. Handy (1989) pictured essentially the same sort of employment relationships via a three leafed *shamrock* structure. Outsourcing is thus seen as a key mechanism in meeting strategic, organisational and employment objectives.

In the UK there has been the additional driver of successive Conservative governments' promotion of outsourcing as a means of cutting costs and improving efficiency. The Conservative belief was that the introduction of market mechanism in the public sector provided the means to achieve these ends. Thus

they created internal markets where they did not exist (*eg* in the NHS), through *market testing* they required public services to be compared on cost with the private sector and they transferred activities into the private sector, through denationalisation and *compulsory competitive tendering* (CCT). This has meant that over the last 15 years ancillary work, and later professional services, in central, local government and the health service have been subject to market challenge. This has had the effect not only of sending a signal of approval that outsourcing is a good thing, it has also expanded the capacity of contractor organisations to deal with increasing demand.

Private sector organisations meanwhile have had to respond to the greater intensity and breadth of competition, the growing speed and cheapness of information transfer, and the increasing demands of customers. They have also had to deal with the consequences of recession. They have done this in a variety of ways including:

- rationalisation — cutting costs through reducing numbers
- simplifying structures to speed decision making
- devolving power to operating units to improve responsiveness
- acquisition and disposal to maximise shareholder return
- focusing on quality of service or production.

Management interest in the size, shape and structure of their companies has meant that all activities have had to be justified and their optimal configuration found. Techniques such as business process redesign have been used to assist this evaluation by understanding how key processes interlink. This may challenge the current organisational structure as better means are found to meet service or production imperatives. The results have been various. Many organisations have chosen to de-centralise so as to put responsibility closer to where decisions are made and closer to customers. Delayering has been used to speed decision making by reducing the intricacy of the hierarchy. Alternatively, other organisations have adopted matrix structures, which are arguably more complex but have the advantage of reflecting the importance of competing interests. A number of companies have opted for *vertical disintegration of production* because they have discovered that complexity is too expensive. Information can so easily and cheaply be transferred externally it may be felt that there is no need to manage it purely internally.

This has meant that previously self contained and integrated organisations have been broken up, and a looser set of connections between semi-autonomous groups established. Some companies have gone further and chosen project based, amoeba-like, forms which are endlessly adaptable.

These trends have encouraged outsourcing by generating questions about structures, costs and efficiency. The move away from the command and control philosophy to one that accepts looser relationships is conducive to transferring work to third parties. The same conclusion is reached by the realisation that the benefits of carrying out work internally may not be sufficient to outweigh the cost savings to be obtained by outsourcing. This is particularly true during recession where the focus is naturally on cost reduction. Moreover, if the supply of labour is not likely to be tight then there is no reason to 'hoard' it. Outsourcing activities is an almost natural follow on from many of these developments. There have been other reasons:

- *Just in time* (JIT) techniques of production and scheduling argue for greater responsiveness and flexibility in supply.
- The need to meet quality standards or implement quality improvement initiatives has challenged current work arrangements.
- Growing sophistication in office technology has gone beyond the capacity of some companies to manage, despite the parallel technological improvement in the simplification of data handling.
- The prevalence of mergers, de-mergers, take-overs and joint ventures in recent years has required managers to decide whether to retain or dispose of activities. The increase in cross business partnering in order to acquire expertise or financial resources, gain access to markets or to technology is seen by some as creating a model by which outsourcing could be judged.
- The pressure to re-structure work arrangements to respond more quickly and efficiently to demand, at reduced cost. This has involved job/role redesign and a growing interest in various forms of flexibility.
- The perceived need to change attitudes, behaviour and values by some form of cultural transformation.

1.2 What do we mean by outsourcing?

Before we go further we need to be clear about what we mean by outsourcing. The ideas we have reported above have in common that they describe, initiate or advocate a move of activities from their previous place within organisations to outside. Thus we wish to concentrate on those situations where organisations have chosen to buy in services or have tasks performed for them which they would previously have carried out themselves. This is what is at the heart of our definition of outsourcing:

> *where an organisation passes the provision of a service or execution of a task previously undertaken in house, to a third party to perform on its behalf.*

We use the term outsourcing (or contracting out) in preference to *subcontracting* since the latter, as we have seen, has a long history associated with engaging third parties to do work which has never been done in house.

Our focus is not on minor adjustments in the 'make or buy' decision but the transfer of whole activities to external control. Thus the management responsibility would be taken on by the contractor. This may or may not involve the physical transfer of equipment or of ownership rights to that equipment. It would however normally mean the displacement of an employment by a commercial contract as existing employees cease to be employed by the client to perform the particular activity. Strictly speaking it would exclude greenfield sites where some tasks are carried out on a contracted basis, but they may be included if the employer has previously performed them in house on other sites.

1.3 Purpose of report

The purpose of the report is to

- describe the extent and nature of outsourcing
- consider who decides to outsource and why
- outline why outsourcing is chosen, and its perceived advantages
- outline why outsourcing is rejected, and its perceived disadvantages

- discuss alternatives to outsourcing
- consider how outsourcing is best managed
- discuss its impact on employees particularly through the legal position
- speculate on what its future might be.

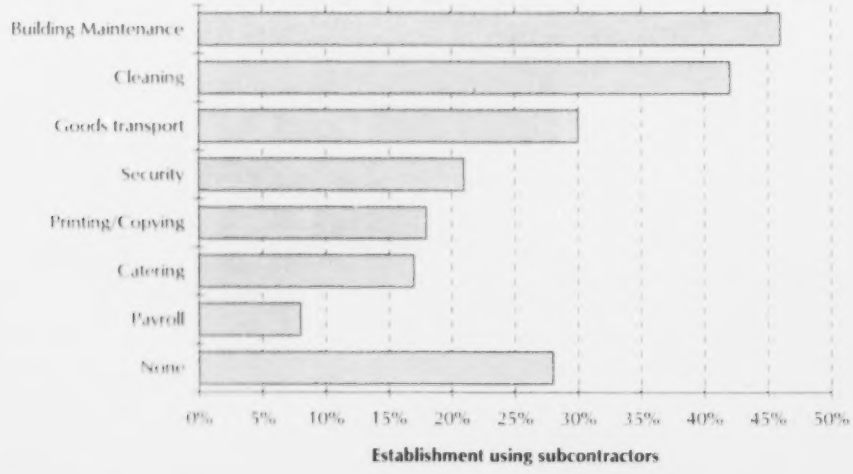
We look at these issues both within the private sector and the public, though with the principal emphasis on experience of outsourcing in local government.

The report has been funded as part of the Institute's Co-operative Research Programme. It is based on an extensive literature review, interviews with a small number of local authorities, companies and contractors. For reasons of confidentiality they are not named in the report. Where named examples are given they are taken from published literature. Because of the limited scale of the research and the lack of hard, quantitative information on the nature and extent of outsourcing, the report is not a definitive account of the current state of outsourcing. It is rather a commentary on the issues which appear to us to be important. Despite the deficiencies in the source materials, judgements have been made on future trends. Readers will have to bear in mind the quality and quantity of supporting evidence when assessing the views put forward.

2. Extent and Nature of Outsourcing

It is very difficult to indicate the current extent of outsourcing and how it is grown over recent years. There are very few studies which can be relied upon, and there are also problems over definitions. The most comprehensive is from the Workplace Industrial Relations Survey (WIRS). This produces a representative result for larger organisations but its data is now six years old and it concentrated on the outsourcing of ancillary services. Figure: 2:1 shows that three-quarters of surveyed firms contract out at least one of the specified services. Nearly two-fifths of respondents also indicated that the value of outsourced services had increased over the previous three years. Less representative surveys (Employee Labour Use Survey, ACAS and the CBI) in 1987, 1988 and 1989 respectively had come to

Figure 2 : 1 Estimate of employers' use of outsourcing, 1990



Source: Millward, Stevens, Smart and Hawes, 1992

broadly the same conclusions, also indicating an increasing trend over the late 1980s.

The impression that the use of outsourcing was concentrated in ancillary activities, and that it was relatively marginal both as a proportion of the workforce and in terms of its organisational impact, was confirmed by a small scale research project in South Wales (Bresnen, *et al.*, 1994). This showed that in 1991, 78 per cent of their sample outsourced work, but it represented less than five per cent of the workforce. It demonstrated that outsourcing was restricted to non-technical ancillary activities, and even for those tasks where it was most common (building work, cleaning, transport, catering and security), a substantial minority of between one-third and one-half still used in-house providers. Finally, only a small increase in outsourcing was reported between 1988 and 1991; in fact in line with the CBI prediction from their survey.

What of the rest of the 1990s? If one relies on anecdotal evidence and the reports in management magazines, one would conclude that following areas should be included in any account of outsourcing:

- information technology (IT)
- other HR services besides payroll
  - recruitment
  - resourcing
  - relocation
  - training
  - pensions administration
  - relocation assistance
  - outplacement and redeployment services.
- logistics besides goods' distribution (particularly warehousing)
- legal services
- car fleet management
- engineering activities besides management of buildings, including maintenance and specialist engineering work.

In the IT field, the use of external help goes back a long way. EDS had data processing contracts as early as 1963. These

facilities management arrangements do not fully fit our definition and strike those involved as rather different in nature. An IT manager at McDonnell Douglas described these bureaux as *'like the phone or electricity company. We paid for the services used'* (quoted in James, 1993). There are now many examples of true IT outsourcing since what has been described as Kodak's landmark transfer in 1989 of its network management to DEC, its PC and desktop management to Businessland and data centres to IBM. The US is, not surprisingly, ahead of the UK in these developments. However, there are many notable UK examples now, *eg* involving organisations of such standing as BP, the Inland Revenue and ICI. Services which have been reported as contracted out include:

- mainframe operations
- network operations
- application software design and maintenance
- systems planning
- pc maintenance
- disaster recovery
- user/technical support.

However, we do not know how common outsourcing is, nor how significant the nature of the change, be it in IT or the other functions. These well publicised cases may be the tip of a large iceberg or really quite exceptional. Until a proper representative survey is conducted (such as the next WIRS planned for 1997) we are dependent upon periodic surveys by consultants and on press reports of big deals.

One of the problems of industry surveys is that they cannot always be relied upon for disinterested accuracy, and tend to concentrate on future aspirations rather than current facts. Nevertheless, a PA Management Consultants' survey conducted in 1993, whilst confirming that IT outsourcing had become widespread, indicated that the approach remained largely short term and small scale, rather than a strategic shift. This was illustrated by the fact that 70 per cent of the reported contracts were for one million pounds or less. Limits to the extent of IT outsourcing were confirmed in a 1995 survey by the Institute of Data Processing Management which suggested that whilst the move towards outsourcing was still increasing, the rate of growth

was slowing. It went on to say that in the larger organisations a more selective approach was evident, with outsourcing restricted to specific technologies and products (IDPM, 1995).

In other areas it may be that organisations are making more extensive use of recruitment agencies, commissioning more external training, or relying more on legal services outside the firm, but this may only imply a temporary, tactical adjustment in sourcing work rather than a major change in labour utilisation. Until we have more information it is hard to be certain.

3. Why Outsource?

This question can be examined at a number of different levels. There are theories of how such decisions are taken, and there is practice. The latter can be based on a management philosophy, or be a response to specific problems. It may be a choice made against a range of alternatives or an *ad hoc* decision. This can be affected by who takes this decision and where they are in the organisation.

3.1 Underlying rationale

3.1.1 Theory

According to Johnson (1987) strategy concerns amongst other things the scope of an organisation's activities and the resources required to undertake them. On this basis, outsourcing would be regarded as a strategic decision because it determines what is bought in and what is developed internally. In which case one would expect that it to be the result of a conscious choice. One model which could be used is that of the 'flexible firm' (Atkinson, Meager, 1986). This suggests that organisations distinguish between activities which are core and those which are peripheral. The characteristics of peripheral work are that it has:

- low or generalised skill requirements
- internally focused responsibilities
- well defined or limited tasks
- jobs which are easily separated from other work
- no supply restrictions.

If an activity has the above attributes it could be a candidate for outsourcing.

An alternative model is based on the business management theory that before making a decision to perform a task internally or externally, management would:

- scan the environment
- analyse the options
- assess the relative cost of each
- chose the cheapest solution.

Through *transaction-cost economics* Oliver Williamson has provided a theoretical framework for applying this analysis to the decision as to whether it is better to opt for a market solution to buy, or the internal solution to make. He has done this by examining the costs of managing transactions and comparing production costs. On this basis companies can choose what he describes as the *'most economical governance structure'* (Williamson, 1979). The key dimensions of transactions from the client's perspective are

- the degree of uncertainty
- the frequency of the transaction
- specificity of the activity or investment, ie
  - how locationally bounded is it
  - how specific is (for example) the equipment
  - how specialised is the human knowledge.

Williamson asserts that on the one hand production costs are lower when managed via markets, due to the economies of scale that can be achieved by a specialist supplier which can cover its fixed costs over a higher number of units of output and obtain volume discounts on inputs. Its labour too is likely to be more efficient, through specialisation. However, these advantages disappear once the product becomes bespoke and frequently produced (Williamson, 1979). On the other hand, market arrangements need to be closely monitored, otherwise the supplier will seek to take advantage of the client through 'opportunism' (Williamson, 1973). This involves a lack of honesty in behaviour or *'self interest seeking guile'* (Williamson, 1973). This sort of exploitation is particularly evident where

there are a small number of vendors. Internal management does not have these governance costs because all those employed should be working for the common purpose of the firm's profit maximisation. There are also advantages in continuity, communication and control that should lead to better efficiency and performance.

On the basis of this analysis, outsourcing would be favoured where:

transactions are non-specific, irrespective of their frequency or uncertainty.

In these situations buyers benefit from the inherently lower production costs of using a supplier. These highly standardised transactions should be relatively easily managed, and if the contractor fails, the client can also turn to other sources because the task is not that specific. Thus the threat of using a market alternative should keep opportunism in check.

Whether these activities are regular or not is irrelevant, because either way co-ordination and production costs are relatively low compared to internal arrangements. Similarly, uncertainty can be managed because trading relations are always available for a specific product, and adaptation is easily made.

Outsourcing can, however, also be chosen where the transaction is specific and infrequent. Production costs will be high if done in house because of the infrequency, but equally managing a one-off contract is also expensive. It has to be recognised though that this will lock both parties into the arrangement, particularly where there is investment in physical capital. If the supplier is required to acquire specialised equipment for this task only, they will be most reluctant to terminate the contract. Equally, though, it will be difficult and presumably expensive for the client to do the same. Given that both parties have a strong incentive to see the contract through to completion, there is a predisposition to settle disputes.

Alternatively, companies could decide to retain activities in house where:

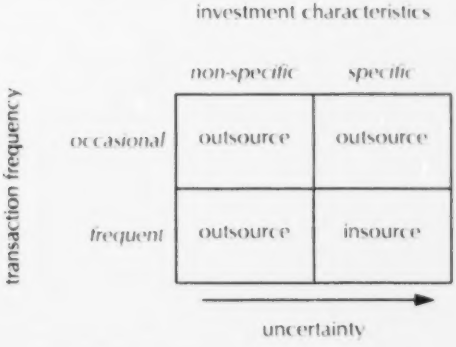
transactions are very specific, are frequent and subject to high uncertainty.

In specific transactions there is unlikely to be a true market to exploit and thereby gain a cost advantage. This is especially true where the specificity comes from the knowledge and expertise of employees. Clearly these are not easily transferable assets (although legislation might try to make them so) and take time to replicate. There is also a cost associated with managing a complex contract, particularly where awareness of information is asymmetrical. That is, the vendor would have to incur high costs and take risks in seeking to ensure that the supplier is sufficiently aware of what is needed. In addition, there are no benefits in lower production costs because an in-house producer can be as efficient in repeat production of bespoke items.

Uncertainty is important because arrangements where possible future situations are complex or hard to anticipate are ripe for exploitation. Where the uncertainty is self evidently the result of external factors which have no price implications, these may be accommodated, but where money is involved this is more difficult to adjudicate due to its *'unfortunate zero sum quality'* (Williamson, 1979). Instead, the firm itself is better able to take the long view and adjust to market circumstances *'in an adaptive, sequential manner'* (Williamson, 1975).

Williamson's analysis is depicted in simplified form in Figure 3.1. Although this account appears more appropriate to manufacturing choice, it is in fact equally applicable to the decision to acquire or provide all goods and services externally or internally. This is because of stress on transactional rather than production costs in Williamson's account.

Figure 3 : 1 Williamson's model of transaction cost analysis



Source: IES

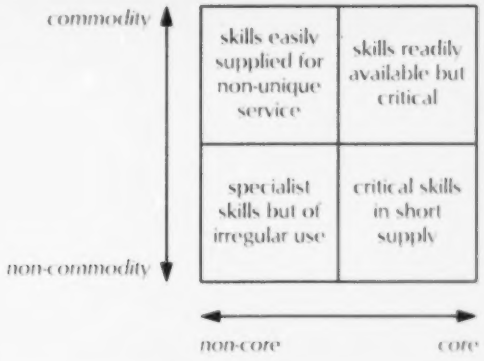
However, as Williamson himself acknowledges, life is not as simple as this. Large organisations can often achieve their own economies of scale both in production and service costs, which the market may find hard to replicate. Knowledge is imperfect, so weighing alternatives may not be that easy, either because information is incomplete, or is unknowable at the outset. Some important items cannot simply be reduced to cost assumptions.

Moreover, this sort of analysis has been criticised as a descriptor of actual behaviour because, it is argued, human beings do not always make logical economic decisions in the way described; sentiment or values may influence their judgement. There are also a number of assumptions about how the various actors behave which are questionable in their simplicity and universality, *eg* it is not only the contractor who might behave opportunistically! (See for example, Francis *et al.*, 1983, for such a critique.) Furthermore, it is argued that strategy making may not be as deliberate and rational as Williamson might wish. Strategies, it is suggested, emerge through a series of one-off decisions and only become clear afterwards through forms of *post hoc* rationalisation (Minzberg, 1994). Other writers have stressed the importance of the uses of power (*eg* Pfeffer, 1981) or the existence of prevailing culture (*eg* Johnson, 1987) in how decisions are actually, rather than theoretically, made. Instead of the decision resulting from an objective analysis of the facts, those with power may use it to influence the outcome in ways that suit their purposes. Alternatively, consideration of proposals takes place within the limitations of the culture and ideology of the organisation, which makes certain options acceptable and others not. Either way the decision processes used may well be informal and characterised by bargaining, without the weighing of options against defined criteria in, say, cost/benefit terms.

3.1.2 Practice

Outside the public sector, where most outsourcing is the result of legislative requirement, it often hard to determine the process that leads to contracting out work. There is little published research on the subject and many organisations are naturally wary of disclosing how such decisions are reached. From the literature and our discussions some conclusions can be suggested.

Figure 3 : 2 An Example of an Analytical Outsourcing Decision Model



Source: IES

The rational strategic

There are a number of organisations which base their decision to contract out on an analysis of their core business areas or competences in a similar way to the flexible firm model. An example is shown in Figure 3.2. This uses a core/non-core distinction together with a supply indicator: is there a ready supply of labour with the requisite skills or an absence/shortage?

This still begs the question of the definition of the core and how it is arrived at. Some organisations have merely identified those activities which are core and those which are not based on implicit criteria. Other organisations may make a more explicit judgement distinguishing between those activities that are considered the source of its competitive advantage and those that are not. Yet this too requires further analysis, as it is by no means immediately apparent what provides competitive advantage.

A different method is to look at the processes, to determine what is critical to successful performance. Techniques such as activity analysis and business process redesign may help to identify the key elements. Thus it may be said that strategic or financial management are core processes, as are the management of external relations, including supply contracts, or design rather than production. Another approach is to decide which are the skills that the organisation above all else needs to control or nurture.

The UK government (HM Treasury, 1991) when considering what could most easily be outsourced as part of its market testing programme developed the following set of criteria which combine several of the features we have discussed:

- resource intensive in financial terms
- discrete
- specialist support services
- fluctuating work demands
- subject to rapid technological change
- problematic supply (costly to recruit, train and retain).

Whatever the criteria used, further judgements may be made to determine whether there is enough of a market to ensure satisfactory supply and, if activities are to be retained in house, whether there are sufficient resources to make them competitive. It was on the basis of the latter that Cumins Engines decided to outsource piston manufacturing because there was too great a cost in becoming competitive (Venkatesan, 1992).

The ideological purposive

Other organisations, (unlikely to be many) have by contrast taken an ideological position in favour of outsourcing. This is epitomised by Tom Peters' exhortation: *'The cry from the executive suite should become 'prove it can't be outsourced'* (quoted in Rock, 1995). The basis of this view is that tasks performed internally are by definition more expensive because they are not market sensitive; management attention is diverted away from key issues, and unnecessary overexposure and inflexibility is risked. They believe in-house arrangements generate work and result in over-staffing. Some have taken this further by arguing the need to create what have variously been described as the *virtual, modular* or *minimalist* organisation. Size is restricted as much as possible and the organisation works through a series of loose and temporary networks assembled to perform specific tasks as required. It is more of a theoretical than actual construct, though there are examples such as Nike or Dell computers.

There are examples too of management choosing to outsource as part of a process of organisational transformation, in order to change employee attitudes to work. The aim is to get employees

more focused on objectives such as cost reduction or customer service. *'The staff are more service oriented and less complacent — shaken and improved' The British Journal of Administrative Management,* (*British Journal of Administrative Management*, 1995).

The quoting of Nike or Dell points to the fact that in the clothing or IT industries, speed of response to changing fashions or technology in a very competitive world demand flexible work structures. This sort of arrangement is therefore more likely to be found in the service sector which has more than most made a deliberate move to more flexible work arrangements.

The ad hoc pragmatic

However, in general, research suggests (Hunter *et al.*, 1993, Bresnen, 1994 and Perry, 1992 on the basis of similar evidence from New Zealand) that these sort of decisions more frequently do not form part of any coherent resourcing strategy. Rather, they are *ad hoc* and opportunist in nature, to meet short term and temporary needs. There is evidence, some of it admittedly anecdotal, that suggests that decisions tend to be made on grounds of cost reduction and driven by the finance function, rather than on strategic business or resourcing grounds. The emphasis is often on cost control over the short term, with little attempt to consider longer term implications; a 'reflex' response *'to get the business through a crisis or to secure a transition'* (Hunter, 1993). It is not surprising that cost predominates as the driver, when organisations are under constant pressure to slim down and the candidates for outsourcing are ancillary services where value for money may be the prime concern. There is also some evidence that outsourcing has been done imitatively because other companies are doing it. Companies are under pressure from gurus, press and vendors to follow the trend. Finally, there can be similar internal causes where it is thought that 'brownie points' will be earned by managers if they sponsor outsourcing proposals. *'IT managers may initiate outsourcing decisions for the purpose of enhancing their credibility ... by showing ... senior management that they are corporate players'* (Lacity *et al.*, 1994).

3.1.3 Location of decision

One way of understanding the basis of decisions to outsource is to look at the locus of decision making. Where there is a strategic approach to outsourcing, senior corporate management is likely

to be involved; whereas where judgements are more pragmatic, decisions may taken at operational level. However, this may vary by activity depending upon its perceived importance to the organisation. Thus where a decision is seen as affecting the nature of the enterprise, it may be taken at corporate level; where it is merely a cost saving exercise, then it may be determined at operational level.

As the political strategy theorists might expect, irrespective of the level of the decision, those immediately involved in the service provision may or may not be involved in the decision making. Senior management may, for example, deliberately exclude the relevant direct line management from participation because of suspicion of their motives. They may feel that these line managers will protect their own interests and will not view the issue from the overall corporate perspective. In other words, they expect that they will try to obstruct the decision to outsource. Those however that are seeking brownie points, or see some personal financial advantage, may argue in favour for less than objective, corporate-benefit reasons.

In a less Machiavellian way, the HR function's involvement may be restricted to dealing with the consequences of the decision (particularly the legal) rather than be party to the decision itself. This is more likely where cost is the predominant motive rather than supply or skill issues. This is consistent with the evidence that HR's role is commonly seen as operationalising business decisions rather than sharing in them (Purcell *et al.*, 1994).

3.1.4 Impetus for change

Clearly some outsourcing in the public sector (through CCT) is required for political reasons and will be excluded from our account. For companies making a voluntary decision, the decision to outsource rather than any alternative approach may be driven by history or the circumstances of the moment. There may be a problem of long standing that an activity has delivered a poor service or at a high cost. Internal solutions may have been tried without success, perhaps because of resistance from entrenched interests. Externalisation is then seen as a last resort. Alternatively, the idea of outsourcing may be of recent origin. At its simplest it may come about from a proposition by a contractor to provide an improved service. It could arise if restructuring has cut numbers to such a low level that there insufficient capacity to sustain the activity or continue it in the future,

because there is no longer any scope to attract or grow employees. Organisational changes, such as decentralisation or a new management structure, may be the impetus to review service provision. Outsourcing could arise out of diversification or acquisition where the company has limited expertise in a new business areas. It could come about through the need for technological change. This is particularly true in IT (*eg* the move to distributed systems from mainframe operations) where the organisation may not wish to invest in money or resources to become sufficiently capable. Added impetus for such a move would occur if there are difficulties in recruiting and developing staff with the requisite skills. Conversely, resources may be concentrated on emergent technology, leaving the management of the declining technology to a contractor.

3.2 Specific reasons

The reasons behind outsourcing may vary with the type of activity being outsourced. Thus it seems reasonable to postulate that cost reduction would be the prime incentive where ancillary services are to be contracted out; whereas for higher value work (such as IT) quality and nature of service might be key. Where appropriate, such distinctions will be made, but it is also true to say that a complete distinction between cost and service motivations is an over-simplification. Outsourcing any task is likely to have elements of cost and service, though one may be the predominating motive in particular circumstances.

3.2.1 Cost

Trying to reduce costs has always been one of the principal, if not the principal, reason for outsourcing (British Journal of Administrative Management, 1995; Lacity, 1993; or Bresnen, 1994). As we saw in the previous section, decisions to contract out have commonly been made on financial grounds where obviously the cost of service provision has been the main focus. It is also probably true to say that in the early days of outsourcing, when ancillary services were the main candidates, it was not surprising that cost was the issue. This is because catering, cleaning, security, building maintenance *etc.* were seen as activities which should be undertaken at least cost. There was no suggestion that these activities were a key to business success. The skills required were generic and available in the

market. They are clearly peripheral, using the definition from section 3.1.1.

A particular issue for large firms was that wage rates were integrated on a company basis, making some services too expensive because of the overheads they had to bear. It has been suggested that firms have found it easier to externalise these services than to solve the problems of pay comparability internally by lowering wage levels. Indeed, this is supported by evidence that establishments that pay high wages for some occupations pay well for others and feel constrained in changing the situation (Abraham, 1993).

As we will see in Chapter 8, the ability of the contractor to achieve these savings through payroll reductions has become progressively harder as the effects of *Transfer of Undertakings* (TUPE) legislation have become evident. If a transfer of labour does not take place, clearly the contractor is free to set wage rates as far as the market will allow, and determine numbers as they see fit. If they are required by TUPE to maintain terms and conditions, there are still areas where cost reduction can be achieved through:

- achieving economies of scale
- higher labour productivity
- more efficient deployment of labour
- numbers reduction through attrition
- erosion of old terms and conditions
- cheaper or no pension arrangements.

These cost savings are likely to become easier over time as the impact of TUPE reduces. This point is discussed in section 8.

For the non-wage items, the contractor can achieve cost reduction through the benefits they can derive from having specialised in a service, and from the size of the operation. Thus their total numbers of staff can rise and fall in line with the needs of their clients; staff can be redeployed from one organisation to another to meet swings in demand; greater expertise can be deployed in organising the work; wider geographic coverage may well be possible. Thus the contractor can achieve advantages over their client in numerical, locational or temporal flexibility. This may be supported by employment contracts which allow greater

managerial scope to deploy staff so as to minimise cost and boost productivity.

Another advantage is that the costs move into the *variable* column from the *fixed*, thereby lowering the cost base. This is particularly important in areas such as IT with its voracious appetite for capital expenditure, and in organisations (particularly in the public sector) where there is stringent control on capital expenditure. It also allows resources to be released for other, perhaps more important, activities.

3.2.2 Improved service

As we have noted, the cost advantage is perhaps becoming less significant, while the quality of service is becoming more important. This is particularly true when more sensitive areas of work are being transferred, such as IT systems, recruitment, pensions management *etc*. However, as we suggested earlier, standards of service are a significant issue whatever is outsourced. Paying people the wrong money or poisoning them with bad food can have a very deleterious effect on staff morale and productivity!

The principal advantages of outsourcing to improve service are seen to come through:

Access to specialist skills.

The use of a specialist supplier — somebody whose *raison d'être* is to provide that service — should permit access to skills unavailable to the client. This applies whatever the task but is probably more valid for the technologically more specialist. It may reflect a changing labour market situation where certain skills may have become scarce and/or not attracted to the client's operation. As BP Exploration's IT manager put it when talking about virtual reality technology, *'the most innovative technologists in this field want to work for small leading edge companies, not big oil companies'* (Cross, 1995).

Access to up to date technology.

Often complimentary to the above, the client may not feel they have the capability, in time, money or resources, to keep up to date with changing technology. This again is especially true where high technology or high cost equipment is required.

Advantages in size or geographic spread.

Contractors may be able to improve on speed of service and consistency of delivery by exploiting their advantages in size or geographical spread. This is evident in distribution services where a multi-purpose distributor can support a wider network than a manufacturer with specialist outlets.

Product or market knowledge.

The supplier may have expert knowledge of a market unknown to the client (*eg* distribution of goods overseas) or of the business product (*eg* car leasing).

Avoidance of internal controls.

The contractor may be able to improve on an in-house service if the latter is overly constrained by controls. These may be in terms of use of capital, the setting of wage rates, budgetary systems or headcount numbers. Outsourcing can escape these restraints.

3.2.3 Focus on core business

This has been a general theme of organisations in recent years. After a not wholly successful rush to diversify in the 1970s and 1980s, many companies are following the Peters and Waterman injunction to stick to one's knitting. This is due to a feeling that managerial competence has become too thinly spread, and involved in areas with insufficient expertise in non-core activities, *eg* catering, cleaning, maintenance *etc*. This is emphasised in situations where there are industrial relations problems and poor productivity, or insufficient managerial understanding of complex technologies. This can be put positively: *'we are not in the business to build computer systems'*, said an American Airlines executive to justify outsourcing IT (Lacity, 1993). Or put negatively, outsourcing IT was decided so as *'to eliminate a troublesome function'* (Lacity, 1994).

At the same time, divesting oneself of non-core activities should free up managerial time from peripheral tasks and allow concentration on the key issues for the core business. There is a recognition of the opportunity costs of investing time in unimportant activities, particularly when managers are hard pressed. This is true both within functions and between them. Thus senior management may hope that it has to spend less

time on IT matters, whilst the IT manager may hope that with the service delivery in the hands of the contractor they can concentrate on the more strategic issues. BP's Exploration manager, John Cross, compared it to moving from the engine room, focusing *'on the mechanics of running the engine'*, to a position which provided alignment with the bridge (quoted in Rock, 1995).

3.2.4 Reduced exposure

Some companies favour outsourcing not just because it avoids diversion of management time to unimportant things, but also to protect themselves against such eventualities as:

- the costs of downsizing
- adverse publicity
- changes in regulation and legal requirements
- changing career expectations.

In other words, all the problems and implications of having to manage change passes to the contractor who has take responsibility. This is obvious in the case of cutting the labour force, since these are now the employees of the contractor, who has to deal with the consequences of a reduced work requirement. But it could also mean passing the employment risk associated with piloting a new product or service to the contractor; if the pilot fails the contractor will have to handle the results (*eg* Argos' furniture experiment 'Chesterman' was managed in this way).

Change can also mean dealing with amendments to employment law (*eg* on contracts), working conditions (*eg* health and safety regulations) or insurance requirements *etc*. They may not fall directly within the ambit of personnel management as they can concern the activity itself, *eg* hygiene rules in catering, or safety in the transportation of hazardous materials. At a softer level, the career implications for staff of the changing value of a service can be taken on by the contractor. Thus if the client believes that a service has become peripheral or marginal, it could be argued that it is more honest to reflect this in a new employment relationship.

3.2.5 Avoidance of headcount based manpower controls

Many line managers have been under pressure to cut manpower as much as cost. Outsourcing enables staff to be taken off the employment books and to appear purely as an operating expenditure cost. Such a decision can be justified as a means of reducing cost or of reducing exposure, but it appears in some cases to have been an end in itself to meet manpower targets.

3.2.6 Flexibility to meet fluctuating supply and demand

This was reported in a recent survey as the principal motive for outsourcing logistics services (Szymankiewicz, 1993) and is a common aim for all forms of flexible working. The need to match labour inputs more precisely to work requirements, be they production schedules or customer preferences, particularly to manage peaks and troughs of demand, is a central part of achieving a cost effective quality service. It can be seen in *just in time* techniques which rely upon the optimisation of labour deployment. Similarly, increasing the hours when customer help telephone lines are in operation is regarded as crucial to the provision of an acceptable service.

One solution is to use your own staff more flexibly by changing working hours, or by employing agency labour to cover non-standard hours, or some combination of the two. The alternative of contracting out is obviously more attractive for infrequently used services, and indeed most organisations would never have done many of these tasks in house (*eg* specialist printing jobs). For those more mainstream activities, it is assumed that the contractor can more easily match demand variations through having a larger pool to draw upon. This allows both a cost saving to be made by not carrying additional labour, and a better service to be obtained through the use of a specialist.

3.3 Validation

There is little public reporting of the extent to which outsourcing has met these various objectives, certainly in the private sector. Unfortunately we know more about why organisations say they have outsourced than about the consequences. Some of the

justification is any case *post hoc* rationalisation. If so, post event evaluation may not have been done, because there are no initial cost/benefit expectations to be met. It may also be that the transfer is too recent to evaluate.

The validation is much easier if cost reduction is the principal aim. PA's survey on IT outsourcing reported that 55 per cent of companies claimed savings, whilst 30 per cent said that costs had increased. Most of the press reporting is more positive about savings made. For example, BP's IT costs are said to have fallen from £350 million to £132 million due to outsourcing (Cross, 1995). No doubt much of the reported savings are entirely valid, but there are problems in assessing the accuracy of these claims. Firstly, is there a true comparison of before and after costs? Secondly, is it a short term assessment of success? The difficulty if the answer is yes, is that contractors tend to make their money in the latter part of the contract term and thus early cost evaluation is from the clients' honeymoon phase. Thirdly, there is an incentive on both parties to claim success.

Validation of improved service can also be undertaken through customer surveys or indices of output. Whilst these assessments are less likely to be made public, they may well be a better indicator of the benefits of outsourcing than cost, because of the difficulties there may be with comparisons. Nevertheless, as we will discuss in Chapter 6, measures of service have to take account of cost and quality.

For local government, savings of between 23 and 30 per cent are reported to have been made through CCT, according to the Audit Commission (see Chapter 7). But as in the private sector, there is very limited analysis available of the quality standards achieved.

4. Disadvantages of and Objections to Outsourcing

4.1 Problems

The problems that have been reported have stemmed from a variety of causes, partly determined by why outsourcing was chosen, and partly by how it was put into effect. If organisations have failed to solve a problem themselves and as a solution transferred it elsewhere, they have tended to find that it has remained difficult. *'In some cases, outsourcing is simply a matter of paying someone else to experience the pain of managing a dysfunctional IS function, rather than trying to figure out how to make the function healthy again. This is a costly form of escapism that sacrifices a valuable component of business strategy for short term convenience'* (Meyer, 1994).

There are other difficulties which have resulted from inadequate or faulty decision making (*ie* choosing the wrong activity to outsource) or poor preparation (entering an incomplete contract). These problems will be grouped together not by their cause but by their effect.

Contractual difficulties

This includes a range of predicaments. At the most extreme have been legal disputes with the current or ex-contractor, or with a third party client.

Disagreements with contractors can occur over such things as the terms of the contract — whether it is being met, whether additional monies should be paid, over the ownership of information, *etc*. These can reach a point where the client or contractor wishes to terminate the arrangement.

Even when it is accepted that the contract terms are being met, clients may wish to exit from contracts because of their deleterious effects, or simply to alter direction or regain flexibility. For example, a US mining company, Freeport McMoran, cancelled a ten-year $200 million deal with EDS because it wanted to change technology.

Perhaps more worrying for clients are law suits, brought by end users in situations where the client thought they had passed responsibility on to the contractor. One could envisage a variety of situations where claims could be made, *eg* food poisoning by a catering contractor, or maladministration by a relocation agency.

Time spent monitoring contractor performance

To avoid these difficulties, careful monitoring of the contractor's performance against the contract is necessary. Some have felt that this has spawned a new bureaucracy and tied up managerial time.

Service difficulties

In a recent survey, only 36 per cent of logistics managers were satisfied with contractor management (Szymankiewicz, 1993). Problems have included:

- a complete failure to perform, *eg* Budgens brought logistics operations back in house after near breakdown of the service (reported in Rock, 1995).
- poorer service performance than anticipated, or inability to meet expectations of improvement. An example of this is where graduate recruitment was outsourced, but the standard of candidates referred for final interview was unsatisfactory.
- a lack of contractor innovation or creativity reported in an IT survey, where 40 per cent of the sample were dissatisfied (Smith, 1996). Even outside high technology areas, there have been similar complaints (Szymankiewicz, 1993).
- the disadvantage of being tied to arrangements which turn out to be inflexible, which cannot respond to changing business circumstances, especially deteriorating conditions. More often, inflexibility is a problem in areas where the technology is immature (particularly true in IT) and changing fast. This difficulty can be exaggerated if a long contract has been entered

into. Thus the client can slip behind the market if the contractor does not enhance its technology. For example, Victor Products, a US automotive parts supplier, found itself with outdated logistics technology and lost market share as a result (Jacobs, 1994). Or the client who signed a ten year contract for mainframe services that meant when migration to client/server technology occurred it was at a higher cost than justified (Lacity, 1994).

- failure to understand the complexity of the task or its connections to other systems. A UK food company is reported to have had these difficulties with a new automation system because the links to purchasing and inventory control were not made (Lacity, 1996).

Loss of expertise to manage contractors

These problems are exacerbated by lost expertise with the result that managing the contractors is extremely difficult. This has happened because insufficient capability has been left behind on transfer and/or the responsibility has been switched from the original service provider to the purchasing department. For example, BUPA had to re-appoint one of its fleet managers to manage an external contract because of an inability to handle day to day operations without specialist support (reported in Rock, 1995).

Problems with user groups

The opposite problem can occur if there is residual control over the contract from the previous managers who have ideas of the standards they expect and are frustrated by the delivery by the contractor. This may result from false expectations of what the contract is intended to provide, due to ignorance of the standards set. This can be even more true for user groups who generally are very demanding of service irrespective of cost and may expect a level of service that was never provided in house. Even without cost issues, end users may have objections to dealing with third parties whose response may well be conditioned by contractual terms, particularly where the specification is insufficient to meet their needs. For example, some specialist IT users may find that the contract does not cover aspects of their work and that the contractor support is less amenable or competent than previously.

This sort of problem arises if the users and contract managers are not party to the terms of the deal. It is particularly aggravating

to clients if the rationale behind outsourcing was to make the contractor responsible for managing uncertainty and solving problems. One CEO responded *'They complained about IT before outsourcing. They complain now — but at least it's costing me a lot less'* (Lacity, 1994).

Employee difficulties

These tend to occur at the time of contract transfer but can be more persistent. The sort of issues which have arisen include:

- terms of transfer
- selection for transfer
- consultation and negotiation particularly with trade unions
- subsequent resourcing problems
- comparison of terms and conditions between those affected.

These issues will be dealt with in more detail in Chapter 7, but here we may note that, whether in applying TUPE or in the quite different legal environment of the USA, legal disputes have occurred. In particular there have been notable cases concerning employee rights to consultation over a transfer, the transfer terms and selection procedures.

In the USA there have been law suits involving ex-Kodak employees and ex-Blue Cross/Blue Shield employees in transfers to DEC and EDS respectively. The employees were successful in the latter case to the tune of seven million dollars.

Unexpected costs

These may arise because of a failure to analyse fully pre-contracted-out services and costs, thus making a poor estimate of the initial contract price. Moreover, the existing service may not have been fully documented in the contract. Thus even to meet intended services may involve extra charges. One company found it was paying more in excess charges than in its fixed monthly price because the contract was inadequately drawn up. This is particularly true if the aim is to ensure flexibility in delivery. These costs can escalate if the implications of change were not recognised in the contract, *eg* that a change of spread-sheet package may seem trivial to the client but is a cost to the

contractor who will pass it on. Finally, if the contract does not meet user needs, costs may arise when users bypass the contract through the development of their own systems or arrangements.

Beyond the service aspects, it may be that the costs of monitoring the contract and managing its control features have not been taken into account.

Another cost implication that organisations seem to have sometimes neglected is that of overhead allocation. If an activity is outsourced it will no longer bear its share of overhead (unless this is built into the contract). Consequently the remaining services have to shoulder a bigger burden, worsening their cost position and making them candidates for contracting out.

Inability of managers to adjust

'The lesson that contracted out involves different management skills and is not an abrogation of management responsibility is one which is being painfully learnt' (Szymankiewicz, 1993).

The sort of skills that may be lacking are:

- third party negotiation skills
- contract management
- interpersonal skills
- inability to manage differences (*eg* between own and contractor employees)
- people management skills (*eg* developing team spirit in a group with a variety of employment relationships)
- integration skills to manage services coming from several sources.

Poor communication between the parties

This was seen as a significant issue in the logistics survey and tends naturally to be worse if activities or management is dispersed, *eg* if contractor management is off site. Problems can occur through such things as:

- the client failing to inform/consult internal users of implications of change

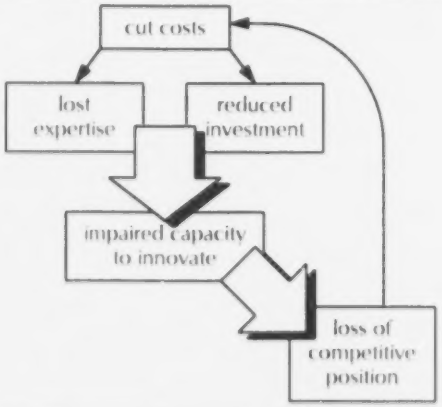
- contractor not advising client of difficulties or opportunities
- client not telling contractor of revised specifications
- failure to delineate the boundaries between contractor and client responsibilities
- dismantling management information systems, thereby making it harder to inform senior management of contractor performance
- problems with the security or confidentiality of information.

4.2 Objections

4.2.1 Fundamental

Some commentators and managers have gone beyond these complaints to make a fundamental case against outsourcing, certainly once it goes further than the clearly peripheral activities. Their principal objection is the loss of competitive advantage that may occur. As illustrated in Figure 4.1, they see a downward spiral, starting with under investment due to an over emphasis on cost cutting, and leading ultimately to a reduced capacity to innovate. This sequence is exaggerated where a risk averse management is too concerned with short term financial performance and is not sufficiently aware of the 'invisible' assets of the firm or even of how the business works.

Figure 4 : 1 How competitive advantage can be lost through outsourcing



Source: IES

A consequence may be that more and more is outsourced or greater and greater reliance is made on partners. The result, it is claimed, is insufficient internal investment and the passing of knowledge and expertise to the supplier who may be able to seize the initiative. This is especially dangerous if the activity is close to important business processes, even if they were regarded as non-core. Illustrating the point is the way some Japanese technology grew on the back of supply contracts from US manufacturers, such as in developing the ability to produce transistor radios (see Bettis *et al.*, 1992).

Proponents of this view believe that the loss felt by organisations through outsourcing is particularly keenly felt in the loss of skills and expertise of staff. Even if not all the key employees leave, the insecurity it creates in the rest of the workforce has to be faced. It means that the organisation is less able to do things itself; its ability to change or develop is reduced; and its capacity to reinvigorate itself is damaged if experienced staff have gone. They fear that the end result would be a 'hollowed out' organisation. Instead they have an inclusive employment model in mind, where all are equally committed to the success of the enterprise. This they believe can only be accomplished by long term employment relationships rather than commercial ones, where skill development and organisational learning are enhanced.

4.2.2 Pragmatic

Without going so far, there are others who have pragmatically weighed the pros and cons and are left with doubts as to the benefits of outsourcing. For example, a survey of logistics managers cited service, flexibility, cost and control as the principal reasons why third party management was rejected (Szymankiewicz, 1993). We will look at these concerns under three headings:

- the nature of the relationship with the contractor
- the impact on business performance
- the internal capacity to carry out the work.

Relationship with the contractor

Some managers believe that there is a fundamental difference of outlook between the contractor (wishing to maximise profit)

and the client (aiming to minimise cost). This distinction means that there never can be a true partnership between client and contractor, and that talk of 'strategic alliances' between the two is pie in the sky. For example, contractors' account managers may be rewarded for increasing their profits by maximising income from a contract through charging additional fees, rather than by making savings of benefit to the supplier. Instead the client can develop a dependency on the contractor, who has no ultimate responsibility or liability. It conjures up a picture of the client being at the mercy of the contractor. Thus the client can find they are being exploited over costs and service or, worse, responsible for liabilities that they did not expect.

This is a problem which some believe gets worse over the duration of the contract. *'What often compromises such partnership arrangements in practice is asymmetrical resources, dependence, and power relations developing over time in favour of the vendor'* (Willcocks, 1995). The dependence increases because the client's ability to manage the contract declines as expertise is lost — precisely the point made above by the opponents of outsourcing.

Business performance

Some fear, as in the above analysis, that business performance will suffer. This could be through becoming locked into an inflexible contract, unable to respond quickly to change, unable to benefit from cost or technological improvements, and suffering in both quality of service delivery and bottom line profits. One cause of the deterioration in customer relations is the loss of control over the key interface between supplier and recipient. In passing it to a third party, the organisation no longer has direct responsibility. For example, Sony took the view that distribution drivers are the 'ambassadors' of the company and should be employed by them (reported in *Business Europe*, 1993).

More fundamentally, there is the fear that outsourcing will bring a loss of competitive edge, not necessarily through poorer performance, but because the corporate offer becomes indistinguishable from that of competitors. Another way of putting this is to say that it is more difficult to sustain the brand image under these circumstances. The company may be represented by the contractor with the latter's livery, uniform or logo, thereby belittling the corporate contribution. The alternative is that

actions performed by contractors are seen as being wholly the responsibility of the client even if the contractor is at fault.

Performance can suffer through the exclusion of those contracted out from full participation in the enterprise. Contractors are not part of the organisational 'cultural web' (Johnson, 1987) of understanding and shared experience. In tangible terms, this may mean that in the longer term the organisation suffers through poor communication, impaired co-ordination, reduced responsiveness, limited flexibility to adjust, and inferior learning capacity. If contractors are not 'part of the loop' they will be less informed; they are more likely to act autonomously; they have other priorities than the success of the client's business.

There is also loss of control over employee selection and deployment. Though it can be specified in the contract who the key contractor employees should be, in general resource management is passed to the contractor. They may not provide the same continuity of personnel, again because they have other interests to protect. Nor should it be assumed that the quality of staffing will improve through outsourcing, particularly if a TUPE transfer occurs. As one manager put it: *'all we did was transfer our weaker staff and then we had to deal with them all over again'* (quoted in Earl, 1996). They may also be trapped into requiring increasingly outdated skills to manage old systems, and be unable to provide the expected technological leadership.

Internal capacity

The third issue is the contention, which may or may not be supported by evidence, that better cost and/or service can be provided in house. This has been the result of many CCT exercises where in-house bids have proved lower than those from external sources. Indeed it has provoked the complaint from contractors that too few invitations to tender are serious outsourcing exercises, and led the government to review the CCT process to identify bias against the private sector (see Chapter 7). Some in the private sector have similarly tested their services by comparison with outside suppliers, *eg* Argos' Castleford Distribution Centre put in a 12 per cent cheaper bid than external bidders (reported in *Business Europe*, 1993).

In big organisations, internal suppliers can themselves achieve important economies of scale and exploit considerable buying power. In all sizes of organisation, in-house managers know

their customers and the context within which they operate much better than outsiders. They can argue the advantages of familiarity and inclusion in the wider formal and informal business processes, as well as a perceived increase in flexibility of response. They can argue that they are committed to the purposes of the enterprise, not to the success of another firm, and that they do not have to make a profit. There are also the short term costs of change, as well as the cost of managing the contract to consider. For this reason some firms put a benefit threshold (*eg* 20 per cent cheaper) before considering changing to an outside supplier. Thus it can be claimed that using one's own staff will deliver a better, cheaper product. Cliff Grange of Hotpoint explained: *'We keep distribution in house for two main reasons, cost and customer service. We take the view that, provided we can manage it properly, we can do it cheaper than contractors'* (*Business Europe*, 1993).

5. Alternatives to Outsourcing

The concerns described in the previous section may cause managers to pause before proceeding to outsource work. Some may believe that difficulties can be avoided by better contractor performance as a result of improving the contracting process. Others may see these problems as an argument to be careful over the activities that should be outsourced, to prevent key processes or competences from being damaged. How to handle these issues will be discussed in the next chapter.

However, some of the reported objections go to the heart of the outsourcing relationship, and so challenge its basis. Managers may wish to understand why it is that contractors can perform a task at reduced cost or improved quality, and still make a profit. This section will therefore look at alternatives to outsourcing that aim to meet the same objectives but by a different route.

Outsourcing can be considered alongside a number of alternative mechanisms. These can be:

- changes to the overall shape and size of the organisation
- introduction of more flexible work arrangements
- alteration to the means of structuring service provision.

We will look at each in turn.

5.1 The overall shape and size of the organisation

Changes can be made to the overall structure of the organisation which allow it to meet the same objectives as outsourcing. Thus, as Figure 5.1 illustrates, reducing the size of the workforce can achieve cost reduction. Devolving decision making, delayering, or in other ways simplifying structures may lead to better, quicker

Figure 5 : 1 Alternative routes to service improvement/cost reduction

Principal motives	Decentralisation	Outsourcing	Rationalisation
Cost saving	●	●	●
Increased accountability	●		
Reduced overheads	●	●	●
Specialist service		●	
Quality improvement		●	
Improved service utilisation	●	●	

Source: after Perry, 1992

decision making, bringing about improvements in quality of performance. If a service is currently under-used, improved take-up may result from redesigning its organisational form. This may lead on to the development of internal contracting arrangements, which we will look at in section 5.3.

5.2 Flexible work arrangements

Besides the above changes, there are a number of initiatives which may be taken to improve the contribution of one's current workforce before one moves towards partial or complete externalisation. In the Atkinson and Handy models referred to in Chapter 1, not only is the *peripheral* workforce expected to be flexible, but so should the *core* group be prepared to alter work arrangements. Taken together, the following benefits can be derived from the employer's own workforce:

- optimisation of supply input to meet demand requirement
- acquisition of specialist skills
- reduction of costs
- improvement in productivity.

These advantages should be realised through functional flexibility, temporal flexibility, locational flexibility and forms of numerical flexibility.

Functional flexibility should result in a more effective internal allocation of labour through better deployment. This is partly an organisational issue (freedom to move labour as required), partly a question of technological improvement, and partly one of

training staff to be able to undertake a variety of tasks. The benefit is clearly one of improved productivity, but there is also an investment cost. Outsourcing may sometimes have been chosen precisely because management has been not been prepared to make this investment, or has been unable to make the necessary changes themselves, perhaps because of employee opposition. It has then been left to the contractor to re-organise because their control over the workforce may be greater.

There is a great variety of different types of flexibility achieved through varying working hours. *Temporal flexibility* offers an advantage for the employee in that it can help meet domestic responsibilities or allow extra income to be earned. Thus it is often sought by employees. For employers, the principal advantage is to obtain a better match between service or production schedules and employee input, sometimes at reduced cost. The choice of arrangement will reflect work patterns which may be standard or be extremely variable.

Some forms of temporal flexibility are traditional:

- overtime
- shift working
- part-time working.

Others are of more recent origin (at least to significant extent):

- flexitime
- flexible working weeks
- annual hours contracts
- term-time contracts
- zero hours contracts.

Employers can achieve some flexibility and reduced costs through *locational flexibility*. This involves using outworkers, home and teleworkers. These arrangements are still relatively uncommon but may grow, facilitated by technological improvement, by employee interest in meeting conflicting home and work demands, particularly in a tighter labour market, and by employer interest in cutting overhead costs or in achieving flexible deployment.

Numerical flexibility can be achieved by the employment of those on fixed period contracts or in temporary, seasonal or casual employment. The advantages found by employers (Atkinson *et al.*, 1996) include:

- matching staff to peaks in demand
- short-term cover for holiday or sick leave

and to a lesser extent in:

- cover for maternity leave
- dealing with one-off tasks
- providing specialist skills
- giving a trial for a permanent job.

However, employers do not always see benefits. Their reservations in order of importance include the belief that:

- temporary workers are less reliable than permanent ones
- they need in house training.

Numerical flexibility can be extended further, such that agency or contractor labour is used to top up one's own workforce. It has grown in importance both in the number of agencies and in their self reported workload (Atkinson *et al.*, 1996). As with temporary employees they are found in both low and high skill occupations. Thus they are used to supplement labour in a catering operation, in plant maintenance, in reception and security, or in computer maintenance, but there also specialists used particularly in information technology, where they are often self employed consultants. The advantages and disadvantages of agency labour are the same as for temporary employees in general, though they are particularly useful to support activities (of declining or emerging importance) where internal resources are insufficient or where costs can be reduced because of lower agency pay rates.

Numerical flexibility can be realised completely through outsourcing because the contractor then bears the brunt of supplying appropriate levels of labour to meet work requirements. This may occur even if the management of the work is retained in house, with the contractor responsible solely, but fully, for resourcing. Where specialist skills are required, *eg* in pensions administration,

it can have the advantage over using supplementary labour from an agency that better quality of input is acquired. Agencies may not be able to provide trained labour at short notice. In outsourcing, the contractor should be able to manage their workforce such that sufficient expertise is always available. In addition, as we remarked earlier, the contractor should also be able to achieve higher levels of temporal and locational flexibility.

Thus the employment options may range from the use of own employees only (with varying degrees of flexibility of use), through supplementing them with agency staff, ultimately to contracting out the whole operation where only third party staff are used.

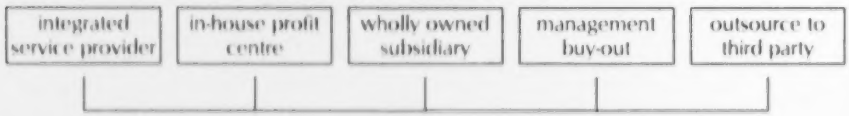
5.3 Re-structuring service provision

Besides this variety of employment options, there are also various organisational steps that precede outsourcing which nevertheless go beyond the traditional deployment of employees. These are illustrated in Figure 5.2

The first variation is to set up an in-house service provider (also known as *insourcing*). This has the advantage of identifying clearly how much the work costs, particularly if *activity based costing* is used. It establishes more clearly what the real demand for services are — if they are paid for as used. Moreover, through the use of service level agreements, it allows more precise specification of what is expected of the provider by the user. Insourcing is in other words a move from *soft contracting*, where controls are informal and social, to *hard contracting* where controls are formal and explicit.

Not surprisingly, insourcing is sometimes used as a precursor to full outsourcing, as it enables management to negotiate an appropriate contract through a better understanding of the costs,

Figure 5 : 2 Options in organisational deployment



Source: IES

and capability to evaluate bids. Alternatively, and more motivating for employees, in-house departments have been allowed to compete with external contractors. Indeed, some senior managers have used the threat of outsourcing quite consciously as a spur to improved performance and reduced costs, and thereby achieved savings which were previously unobtainable (see Lacity, 1996 for example). Under CCT, in-house bids too have proved successful. However, it has been argued that this has often been at some cost in terms of wages (loss of bonuses rather than reduced base pay), job loss, and changes to working arrangements to increase productivity (Colling, 1993 and IRS, 1995).

One issue which needs to be addressed is whether users must take the services of the in-house provider, or can shop around externally. The former is a real test of the value of the service offered. Similarly, will the service provider equally be able to bring in work from outside? If not, it may be felt unfair to judge the performance of an internal operation against external competition, if the insider cannot act in a commercial way. However, some concern may be caused to management if this results in unwelcome exposure or risks to security and confidentiality. There are also concerns about managing conflicts of interest between internal and external customers.

To clarify this situation, some companies have taken the next step of setting up the service provider as a separate company, for example as in Barclays Bank Operations, a wholly owned subsidiary providing IT services (reported in Rothery *et al.*, 1995). The decision to make this move is likely to be judged in terms of corporate benefits in management and finances. Whether it actually makes it easier to take on work from outside the organisation is a moot point. If the service provider remains on company premises, as is likely, the risks are probably unchanged. Thus we may be talking about perceptions regarding exposure that are part of an adjustment process from the traditional to the new arrangements.

Going one step further, the activity can be sold to one's own employees and established as a separate company. It then contracts to provide the service, but as a truly external operation. The difference between a management buy out (MBO) of an activity, and outsourcing is purely one of ownership. Yet it has probably a psychological as well as practical significance. MBOs allow continuity of service by people who are known to the client

and who know its business. In that sense it is closer to insourcing. The decision to sell off the equipment and transfer the work is again a management judgement of the financial and corporate advantages. It also accepts that the new firm will want to extend its business elsewhere and this may in fact be the primary reason to allow separation.

An alternative model is the example of Philips, which went into a joint venture with Dutch software company BSO to form a new company to provide software development for Philips and externally. This gave Philips a secure supply for software and support from staff it knew, at a lower cost, and for BSO a wider customer base and expertise (reported in Willcocks, 1995).

6. How Best to Decide and Manage Outsourcing?

This section is intended to distil *best practice* from the experiences of those who have followed the outsourcing path, as discovered from our own discussions and the literature. As with all best practice advice, it is necessary to set it within the context of the particular organisational circumstances and of what is being outsourced to whom.

6.1 How best decided?

The answer to this question depends on what is being outsourced and its importance to the organisation. Even if the activity is self evidently peripheral, it would seem appropriate to make the decision in a systematic way, to reduce the chances of encountering the problems described in Chapter 4. If it is of more critical importance to the organisation, a strategic review would seem to be necessary. Unfortunately, as we have noted earlier, all too few organisations seem to consider outsourcing on this basis. This may because it involves an investment of time and effort. It may be because it not a straightforward task. The difficulty is that if judgements are made implicitly and not articulated, they are not open to challenge and are not consciously shared. This is particularly true if outsourcing is seen purely as a financial decision and not evaluated in the wider organisational context. The realisation that it is but one possibility to improve productivity and reduce cost is thereby missed, and with it the opportunity to evaluate its advantages and disadvantages compared with other options. The cost/benefits of the chosen route are not identified in advance, and not open to later scrutiny to see whether the benefits have in fact been realised.

If an activity is deemed to be a candidate for outsourcing, a proper evaluation would be required which takes account of:

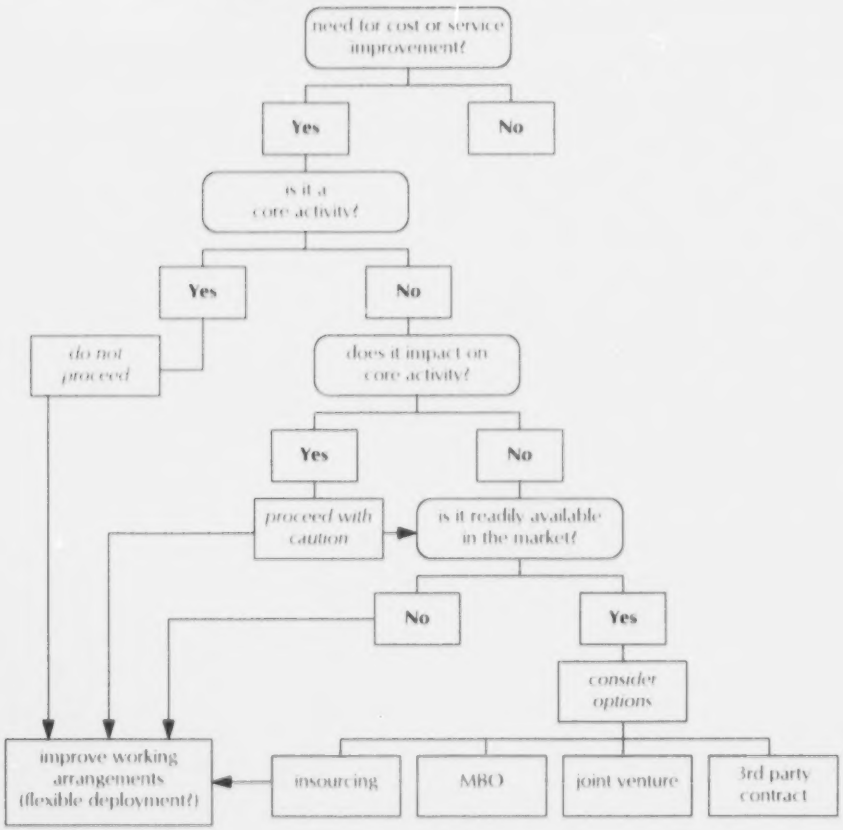
- clear corporate objectives setting out the requirements of the exercise be they cost reduction, service improvement, expertise acquisition *etc.*
- a risk assessment which considers the technological and business implications
- consideration of security and confidentiality issues which may constrain choice
- a full estimation of the cost/benefits, including the non-financial, *eg* skills impact, or cultural effect: to be done on a long- as well as short-term basis
- whether and how the activity links to other core processes
- an evaluation of the market to see if there is sufficient competition of the requisite quality to keep costs down and quality up
- whether the same objective could be met through an internal service provider, perhaps making more flexible use of own employees or agency staff
- whether the alternative external routes, such as via an MBO or joint venture, might be appropriate
- an assessment of the cost of retaining activities in house in terms of human or physical resources
- consideration of tax, legal, and procedural issues which may inhibit or alter the decision to outsource.

The sort of decision making process we envisage is illustrated in simplified form in Figure 6.1.

The word 'core' in the model can be substituted by 'critical activity' or 'source of competitive advantage': the point is to distinguish between those areas where a high degree of internal management control is seen as necessary to protect a vital interest. Determining whether the activities you currently undertake are part of your core business requires you to define criteria on which to make a judgement. These might include:

- uniqueness of resources, be they skills or physical assets, systems or structures
- not easily imitated by others

Figure 6 : 1 An outsourcing decision tree



Source: IES

- providing critical differentiation with competitors and market advantage
- profitability/added value
- nature/size of invested assets
- part of operational integrity
- relationship to brand/customer perception of their singularity.

These should be considered over both the short and long term. This would suggest that some scanning of likely future developments is desirable. What is core is likely to change over time and

greater caution is needed where the picture is complex or unclear. Certainly, if a new activity is being considered, the criteria will have to be applied more carefully. Some companies take the view that experimentation is better managed externally; whilst others would argue that the benefits of learning are thereby lost.

The process we have described takes account of Williamson's questions on the specificity of the service and the importance of there being a genuine market. It recognises the need to confront the future. The greater the future uncertainty, in Williamson's view, the less attractive outsourcing would be. It accepts that there may be alternatives to outsourcing which may achieve the same objectives without some of the difficulties of managing the opportunism of third parties.

6.2 How best managed?

In making the decision to outsource, it is imperative that not only should management commitment to the process be secured, but also agreement on the reasons why it is being undertaken. The next step is to appoint a project team and set a realistic timetable. Thereafter, experience suggests that the management of the process is critical to its success. Whilst there are those who believe that partnership arrangements are possible between contractor and client, it is probably better to recognise the different objectives of the parties, and this should be reflected in how the terms of the contract are established.

At its most basic this would mean:

- drawing up a specification for a contract
- determining a basis upon which to select contractors which will be asked to tender
- inviting competitive bids from suppliers on both price and service
- evaluating the bids on predetermined criteria
- awarding the contract
- setting up management processes to monitor and control its performance.

To most readers this would be obvious, but it is a sobering thought that a quarter of respondents in the survey of logistics

managers worked without any sort of contract (Szymankiewicz, 1993). We will look in more detail at the areas which one might expect to see covered.

6.2.1 Determining the contract strategy

This involves such issues as:

- considering a selective or complete approach to outsourcing the activity
- reviewing whether single or multiple suppliers are appropriate
- examining whether the assets and staff transfer or remain, and whether the service is to be on site or not.

This then sets the broad framework for contract specification.

Which of the options chosen will depend on the nature of the activity being outsourced. Partial outsourcing is sometimes chosen so as to retain a foothold in the field and to provide a point of comparison with the external supplier. This has been common in distribution. Multiple suppliers are used where there is seen to be an advantage in providing external competition (*eg* BP Exploration awarded three separate IT contracts covering different work areas). As to the retention of staff or equipment, the latter may not be significant where it is of limited cost, such as cleaning. With catering equipment it could be retained in corporate ownership, but is more likely to be transferred to the contractor in order to realise a capital cost advantage. In both cases the transfer of staff would be the norm. IT outsourcing can be more complex. A mainframe operation could, for example, be run on site or remotely. In some cases, assets have been retained by the client whilst management and staff have been transferred (*eg* the London Stock Exchange's deal with Arthur Andersen). In other cases the contractor has purchased the equipment.

6.2.2 Spending time on the tendering and assessment process

This message does seem to have been accepted by some, if the growing length and complexity of tender documentation is anything to go by. An increased burden is being placed on contractors to provide more detailed and specific information. However, from the client's perspective there needs to be a clear

contract specification, defining the scope of the work and setting standards set for both normal and abnormal service. Service parameters are likely to include availability, turnaround time/response rates, quality standards, support levels, *etc*. These have to be buttoned down otherwise ambiguities will later become apparent. For example, in a secretarial service, if ninety per cent of scripts have to be returned typed within two days, what happens to the other ten per cent? To achieve this objective, close working between those negotiating the contract (*eg* a procurement department) and the current service provider or future service manager, will be necessary. The views of end users will also need to be taken into account.

In order to judge whether the bids are acceptable, you need to have a detailed understanding of your current costs against your present service. Otherwise it is hard to judge the quality of what you are being offered. Documentation also should be in a form that makes comparison between bids easy to make. This again requires clarity in service standards, but also on whether staffing levels, minimum wage rates *etc*. will be specified. This will mean that a judgement will have to be made on whether TUPE applies or not; although the default position should always be that it does.

When it comes to selecting the contractor, clearly the price and service offered will be key criteria, but the decision is also likely to be influenced by their reputation, track record, your own experience (if any) and the contractor's apparent financial stability. It may also help your assessment by understanding the motives of the contractor — why do they want the business? Where do they expect to make the money?

6.2.3 Determining the contract length

One specific issue to be faced is what sort of contract length is appropriate. Clearly the sort of work involved is critical. Short contracts favour cost driven approaches to contracting and tend to be favoured for lower skill or less complex tasks. These are sometimes described as 'spot' transactions to contrast them with commodity markets. Longer contracts are more appropriate if the handover time is significant and the contractor needs a long learning period; in other words, for work in higher technological areas. This is favoured where there is a wish to develop a 'strategic alliance' between the client and contractor. However, if the latter route is chosen, optimal flexibility in the contract

must be built in. It is optimal because the price to be paid for full flexibility is likely to be excessive. Failure to allow for changes in technological improvement or cost reduction can be expensive. This is particularly true in IT: one unit of processing power that cost one million dollars in 1965 costs $30,000 now (Lacity *et al.*, 1995). It is difficult to predict where costs and technology will go over a ten year period, but contractors tend to benefit the longer the contract. This is partly because discounts are often available in the early years, partly because of increased efficiencies as the contractor gets to know the work better and a consistent income stream has financial advantages in itself. This analysis has discouraged some from entering long term contracts. Others have made contractual provision for changed circumstances.

6.2.5 Developing clear control procedures

This involves setting service levels and/or quality standards, ensuring that there are the means to measure performance, and establishing procedures for handling non-compliance.

The first point can be addressed through a statement of key deliverables rather than on methods, a subject which is better left to the contractor to define. The deliverables used might relate to volume, timing and quality of the output. What can be specified will naturally vary with the type of work; a standard operation such as office cleaning can be much more completely specified than an operational service where it is impossible to cover all eventualities. Likewise, quality can be more easily measured in, say, physical goods than in handling a customer. Thus measurement may vary from simple targets, through such things as customer satisfaction surveys (*eg* for catering) or by benchmarking performance against other service providers.

Whichever method is applied, a regular reporting schedule is necessary. This should include both indices of performance and regular progress meetings. Problems can then be identified and dealt with. If difficulties cannot be overcome, there should be escalation clauses in the contract to resolve disputes, and ultimately notice periods for termination. This may seem unnecessarily negative, but it should be accepted that problems are likely to occur. It should also be recognised that contracts are not static. Initially, mutual understanding has to be worked on such that there is knowledge of respective objectives; it is not something that comes automatically. Similarly, cultural and

other incompatibilities have to be sorted out. As the contract proceeds, different conflicts may emerge, especially if the balance of power begins to favour the contractor.

In dealing with such issues, consideration needs to be given to whether any contractual rewards for success, or penalties for failure should be offered. Examples include allowing the contractor to retain a proportion of the profits from the development of a new product, sharing the surplus from hiring out of facilities, or simply receiving cash payments if service levels are exceeded. A penalty might be a charge against the contract if there is a service failure or if standards are not consistently met. Body Shop in their contract with its distributors, the Lane Group, provided for three elements: cost of operation, a management charge, and a profit margin. They set targets to reduce costs and improve performance, especially environmental. If these were met the profit level increased (Rothery *et al.*, 1995).

6.2.6 Care with transition

This has to be managed both with respect to ensuring service standards are maintained and with changes in organisational configuration. A balance between the two has to be struck, otherwise the focus can all too easily be internal and the needs of the external customer can be neglected. Nevertheless, employee motivation and commitment need to be maintained during such uncertain times.

An early issue which has to be confronted is when and how to communicate with the affected staff. There are two schools of thought. One view is to do it as late as possible, to minimise the risk of sabotage, and only via the incoming contractor, who then has early opportunity to state their case. This means that staff hear directly from their potential future employer who can address their concerns.

The alternative opinion is the diametric opposite. It argues that concerns over sabotage are exaggerated and precautions can be put in place to reduce the risk. The principal aims of the transition, it is felt, should be to gain employee support for the process and minimise fear of the unknown. This, it is believed, will be assisted by early information which avoids rumours developing. This is exemplified by a US company, 3 Com, which told its employees of the outsourcing plan nine months ahead of the scheduled move (Waterman *et al.*, 1994). This option also

requires an open approach and one which demonstrates the client's support for the transfer. As the current employer, it is argued that there is an obligation on them to hear staff reactions and to respond. It is not suggested that the vendor is excluded from participation, merely that in sequence this is a second order priority.

Of course legal rules and local agreements on consultation will impact the timing and nature of how staff are informed, whatever the employer's preferences. These issues are discussed in Chapter 8.

The main way of ensuring successful operation during transition is to provide a suitable handover to the contractor. Again, the nature and complexity (which can be of size as well as of technology) of the work area will determine its length. As an illustration of this, when McDonnell Douglas outsourced the computing facilities for one of their sites, the handover lasted a year, due to the intricate nature of the operation and its importance to the firm (James, 1993). Some of the service failures we have described may have been caused by an inadequately managed transfer of responsibility.

6.2.7 Managing the contract

As shown earlier, there is a need to have sufficient staff to oversee the contract with enough expertise to deal with issues as they arise. This may mean assessing performance against standards, evaluating claims by the contractor, or acting as an interface between end user requirements and the service provider. The latter is particularly important where there are multiple suppliers and the objective is to provide a seamless service.

The growing importance of the role of contract management is illustrated by the establishment in 1993 of the British Institute of Facilities Management. It has launched a qualification to ensure that the requisite skills are covered by those working in the field and, no doubt, to improve their professionalism. Core competences cover business management, people and resources and the physical environment. Specific subjects studied include:

- the use and maintenance of premises
- facilities planning
- the law relating to property

- information processing.

These sorts of managers are specialists in contract management but generalists as to the services provided. This may be sufficient for the less technical activities, but for others specialist involvement is no doubt required. In the McDonnell Douglas example quoted earlier, they retained a technical team of 20 to manage the contract (James, 1993).

6.2.8 The team

As we have seen a number of parties need to be involved in effecting a transfer. This requires good procedures, clear allocation of responsibilities, excellent communication and well organised co-ordination. To recap those who should participate are:

- senior management to ensure the proper objectives are set
- current line managers to provide understanding of the service, advise on standards and to deal with staff issues
- future service managers (if different) to ensure they grasp the cost, quality and contractual issues
- financial staff to ensure a full costing of the service is made, especially such hidden costs as overheads
- procurement or contract managers because they may well carry out the negotiations
- end users of the service to ensure that proper service levels are set
- legal advisors to cover contractual (particularly in determining whose terms of business will be used — preferably your own) and employment law issues
- HR staff for employee relations' advice and as key players in the communication and consultation processes
- public relations people to deal with media enquiries, particularly since outsourcing can be widely reported, especially in the trade press.

7. Outsourcing in the Public Sector: the Example of Local Government

7.1 Introduction

In the post war years until 1979, the provision of public services saw enormous growth driven by the country's pressing need for social reconstruction. There was political unanimity regarding the requirement for new houses, schools, medical services, transportation and the like, and an understanding that much of this should be provided through the medium of public bodies.

This process of expansion and development was carried out in an environment of major commercial growth and a volatile market place, involving competition for labour and scarcity of materials.

The strategy adopted by Local Authorities and other public bodies in these circumstances was based on some simple suppositions:

- service design should be led by usefulness rather any concept of market or profitability
- access to services should be determined by need
- service provision was about mass rather than individual consumption
- public ownership and democratic accountability was preferable to market forces
- public service emphasised standards of employment, job security and good working conditions rather than the simple consideration of money alone.

The guarantee of appropriateness and quality lay in the professionalism of public sector staff, their 'sense of vocation' and their spirit of 'serving the community'. There was little evidence of interest in outsourcing, still less of work actually being carried out externally (Colling, 1993).

This mind set appeared to be unchallenged by citizens who, as consumers, were relatively passive in their acceptance of the provider model and appeared to concede that the provider knew best. But as the rise in customer focus and consumer demand grew in other sectors of the economy, so the public sector came under increasing scrutiny.

Change arrived in May 1979 with the election of a Conservative government wishing to:

- reduce the size of public sector
- limit public expenditure
- gain some control over the activities of public bodies, especially local government
- apply a 'free market' philosophy to local services
- reduce the power of trade unions
- respond to the demand for consumer rights.

The impact was felt right across the public sector. There was and continues to be widespread de-nationalisation — the most complete expression of generating market exposure. There has been the creation of the internal market in the National Health Service (NHS). There has been the Private Finance Initiative and the effects of transferring the management of schools away from local authorities. There has also been market testing and compulsory competitive tendering (CCT). The latter has been applied to ancillary services in the NHS, but it is the example of CCT in local government on which we will concentrate.

As Nicholas Ridley indicated in 1987, there were particular reasons why local government was targeted for change,

> *'you cannot have a free market government using public spending to do what is properly within the public domain at the same time as municipal socialism with its ideology of public ownership.'*

The practical results were seen in the compulsory market testing of most blue-collar (*ie* manual) services within local government through the Local Government Planning and Land Act 1980 (for construction, building maintenance and highways work) and the Local Government Act 1988 (refuse collection, cleaning of buildings and streets, grounds maintenance, vehicle maintenance and schools, welfare and other catering). Some white collar services (sports and leisure management) were added under the 1988 Act; more followed under the Local Government Act 1992 (IT, financial, legal, personnel, construction/property, security, parking services, and housing and vehicle management).

7.2 Why the need for market testing?

If companies in the private sector were responding to the sort of external and internal pressures described in Section 1 by contracting out peripheral services, local authorities were being required to contract out what had previously been regarded as core activities in a competitive process. It is important to recognise this distinction. Whatever the reasoning behind private sector organisations' decisions to outsource (and Chapter 3 identifies that they are many and varied) they at least determined their own outcomes. For the public sector, the locus of control was outside the organisation: it came from a central government that had no faith in the sector's ability to manage the process itself. Nevertheless, some local authorities have embraced outsourcing with much more enthusiasm than others.

What motivated the government to adopt this position and why have some authorities pursued outsourcing willingly?

7.2.1 Central government rationale

For the Conservatives, outsourcing was seen as a means of cutting costs and improving efficiency. It fitted their free market principles which determine that:

- services should be provided by the most cost effective supplier
- consumers have the right to chose who should provide a particular service
- supply should be governed by the rules of price and demand
- competition engenders better and more cost effective service.

The underlying principle was that activities carried out in the private sector were intrinsically more efficient than in public hands. The latter was seen as wasteful of resources because, without the spur of competition, there was no incentive to restrain costs or maximise efficiency. And this was an issue of particular importance with the government's aim of restraining public expenditure in order to reduce taxation and liberate the wealth producing part of the economy. Successive initiatives by government have therefore sought to open up certain activities in the public sector to market forces and confront the providers of local services with a new set of accountabilities.

This implied a clearer separation between commissioning and delivering services. It required local authorities to move from a position where service standards were set, delivered and monitored within the same organisation, to a situation in which there was a division between those who defined the service and those who delivered it.

Besides reducing costs and improving efficiency, another by-product of this approach the government hoped to see was a change in the nature of industrial relations in the public sector, to more like that which is seen in the private sector. Trade unions, the Conservatives believed, had pushed up costs through their wage demands and prevented improved services by their working practice restrictions. Again without the discipline of the market this might be possible, but competition would force moderation in pay and lead to more cost-effective work arrangements.

7.2.2 The local authority perspective

The idea of market rationality being used as the yardstick for organisational decision making was greeted with varying degrees of hostility within the public sector, though there were some Conservative-run authorities which were more positive. In particular, local authority officers and members were simply not used to an imposed set of indicators by which the effectiveness of their operations could be judged. Moreover, it was felt that these initiatives paid little heed to the state of the external market or the ability of in-house staff to compete.

Nevertheless, managers had to meet their legal obligations. Each local authority has developed its own way of identifying what would form part of individual contract packages. This process

was guided to a greater or lesser extent by the existence of corporate objectives, reflecting the management culture, or the nature of political control — which itself affected the predominant norms, most importantly regarding the importance of financial management. Thus some authorities embraced CCT with enthusiasm: Others rejected the underlying philosophy that 'cost effectiveness should be the only measure of quality and complied with the law to the minimum extent necessary.

There also existed a strong lobby in local government which argued for the retention of an in-house team which, although subject to the monitoring rigour demanded by CCT, could still enable the council to:

- mirror its own values and objectives by retaining direct control over delivery
- reduce the overhead costs on other services by assisting in spreading the central service charges over a wider area
- provide employment for local people
- have the flexibility to respond to emergencies
- protect itself from commercial cartels and price rigging
- provide a model of good employment practice.

Thus Direct Service Organisations (DSOs) were given every chance of winning the tender.

However, for many authorities initial hostility gave way to acceptance, and in some cases the realisation that the legislation might have its benefits. CCT provided an opportunity to expose some services to the market where there was:

- a perception of poor in-house delivery, evidenced by the number of complaints
- a lack of customer awareness in service provision
- high cost of provision
- exposure to unacceptable risk of service failure
- an existing external market to provide the service
- difficulty in recruiting quality staff.

In many ways, these reasons mirror those that apply in the private sector, and appear also to be found in the NHS

experience' of CCT. There seems to be a similar mixture of positive and negative imperatives, ideological and pragmatic reasoning. Thus outsourcing was regarded by some as a means to pursue 'service excellence' or, as in the case of IT, to improve service quality. There are also examples where it has also been used to *'do the dirty work for councils'*, *eg* to exit from restrictive trade union deals. Similarly, CCT has been used as a cost cutting device, either in itself or to ensure that the DSO could compete with external providers. In other cases, CCT has been embraced as 'a lever for change', to effect a cultural transformation towards greater performance orientation and a more innovative approach to service delivery. The response to CCT became less of a defensive reaction and more of a vehicle for strategic change. More pragmatically, some local government members saw the opportunity to reduce the costs of services without cuts in service provision, particularly during a period of centrally imposed cash constraints.

7.3 The results of market testing

Making services subject to market testing did not of course equal contracting out. The early expectations in local authorities were that their DSOs could not win contracts, as their own costs, once identified, would be too high, their managers too inexperienced in pricing in a competitive market, and that in any case, in-house teams would be disadvantaged by pricing 'the spirit' as well as 'the letter' of the contract.

The reality is, according to the regular Local Government Management Board (LGMB) survey, that in England and Wales, by late 1995, DSOs had an average success rate of 59.5 per cent. Levels varied on current contracts between 42 per cent for building cleaning and 84.5 per cent for sport and leisure management. These overall figures were brought down by the large number of smaller contractors bidding in some areas. DSOs have won 75 per cent of all works by value, and recent contracts have been dominated by DSOs winning re-tendered works after the completion of the first round periods.

Certainly, the uptake of tendering opportunities has been less than the government might have anticipated. Partly this is due to differences in expectation about the appropriate extent and nature of outsourcing. Some in government no doubt thought that CCT would result in putting the whole of certain services

Table 7 : 1 DSO performance in winning CCT contracts

Activity	DSO success % by number	DSO success % by value
Building cleaning	42.0	71.8
Refuse collection	61.4	65.0
Other cleaning	62.6	73.7
Vehicle maintenance	76.7	80.6
Catering (education and welfare)	74.6	80.5
Catering (other)	61.9	73.6
Ground maintenance	56.0	74.3
Sports and leisure	84.5	92.6
Management average	59.5	74.9

Source: Local Government Management Board, 1995

into the private sector. Others in local government have, as we have seen, tried to ensure that CCT did not necessarily mean the externalisation of services. Those in the middle supported a process where a service was put out to tender with the possibility that either the in-house team or a contractor might win. The poor success rate for contractors has caused them, through their own associations, to lobby what seems to have been a sympathetic government, about their perceptions of unfair practice. Councils have countered by explaining that these results confirm their expressed concerns about the ability of the market to respond to the opportunities provided by CCT.

Support for the local authorities' position comes from evidence gathered by the LGMB survey of tendering procedures in England and Wales, which indicates that on average three-quarters of those applying to be included on tender lists drop out before tendering (the rate varying between 69.8 per cent for refuse collection and 80.1 per cent for building cleaning). A further 50 per cent drop out between invitation to tender and actually submitting a bid.

It may be that in some areas the market for services is still maturing: this view is supported at least by anecdotal evidence. There is also the problem of the way local government finance is planned over the medium term. This has been identified by the Association of Metropolitan Authorities as part of the reason

for contractors' lack of success in the tendering process. It believes that there is a culture gap arising from the limitations in predicting future workloads imposed by the local government finance regime This is supported by the views of a building contractor:

> *'you may be guaranteed an authority's workload, but there is no guarantee of what it will spend over the next few years.'*

Voluntary market testing has also occurred in some areas, usually leading to external sourcing. It has nearly always concerned those activities defined under the Local Government Act 1992 as subject to CCT, but before its terms have become compulsory. According to the LGMB, by late 1995 some 84 authorities were involved in letting 245 contracts, involving in-house bids in only 20 per cent of cases. Voluntary outsourcing was particularly common for financial services and IT, each representing a quarter of all contracts let. Next most frequent were construction and property management (15 per cent), with smaller proportions for the rest. It is thought that IT is the function most frequently contracted out by local authorities (47 in number) because it is seen as a weak performer compared to external competition, unable to attract leading edge employees and a significant drain on capital resources. It seems to be generally outsourced as a single entity, whereas for financial and the other services, packages are more likely to be for separate, discrete activities.

7.4 Benefits of outsourcing

There has been a significant amount of research on the cost savings arising from CCT (Audit Commission 1984, 1987 and 1988, Walker 1993, Walsh 1991) which indicate that there is a substantial saving that has arisen as a result of the tendering process. The Chancellor of the Exchequer claimed in 1991 that:

> *'buying in from a contractor generally means as good or better quality services at substantially less cost. It is common for savings of 23 to 30 per cent to be achieved. It is generally a better way to convert taxpayers' money into consumers' services . . . There are great potential benefits to be had, both in improved quality and lower costs.'*

This view is broadly borne out in the findings of the research. Some local authority managers are more doubtful, concerned as they are that the full costs have not been taken into account:

> *'It is hard to be sure that there are savings once you have added the additional costs of client side monitoring, contract specifying and start up costs' (local authority manager).*

Cost effectiveness is, however, not merely a measure of the cost of the provision of a service but consists of two complementary themes. One is cost, the other is quality: the degree to which the service meets the needs and expectation of users. Often the two benefits are seen as intertwined by commentators. As CIPFA put it:

> *'CCT in the public sector reduces the cost of providing services whilst maintaining quality. On top of net savings from the tendering process, there are unqualified savings from the efficiency measures implemented in the run up to tendering.'*

Proper studies of quality outcome have, however, been limited. Bailey and Davidson in their recent review (May 1996) pull together some of this previous research. They conclude that findings of improved quality may be over-generalised because of problems over the definition of quality, a lack of expert knowledge of service characteristics, and because of the vested interests of those on the client side to demonstrate their own effective performance through improving quality standards. From their own research they conclude that a managerial /professional approach to quality is predominant. This places the emphasis on processes, standard setting and external independent accreditation. There is very little evidence of any significant involvement of providers or users of services, which may be disappointing if one of the catalysts for CCT was consumer involvement or influence. There has been considerable emphasis on the management of the process in the belief that this will bring quality, rather than management of outcomes.

Many authorities have also experienced benefits of outsourcing despite the original misgivings. According to the Department of the Environment:

> *'there is a steady trickle of local authorities who have done CCT, seen it as an opportunity to get their house in order, got the savings, got the efficiencies, now got the specifications and are looking to see what to do next.'*

This is illustrated by the analysis of one authority:

> *'financially it is working, we spent a lot on the transition and we are now making money having taken all our costs, including redundancies into account . . . services have improved, we have Investors in People and ISO 9002 accreditation for a whole range of service . . . customer perception has improved and the community now demands and expects a better service' (local authority manager).*

7.5 Problems with outsourcing

The problems articulated by a number of local authority operators include :

- the inability of contractors to espouse the unwritten public sector values in providing service
- the inability to monitor contractor performance properly, due to budget cuts in both the auditing function and in the client group
- the difficulty of establishing true measures of value for money, either because of the political sensitivity of the question or because there is no established market price (because of the absence of a developed market in some services)
- the problem of the relationship between quality and price, particularly within the limitations imposed by the guidelines
- poor contractor performance, particularly in planning service provision
- financial instability of the contractor
- potential conflicts of interest, where in DSO provision the service provider and the client have been the same
- loss of expertise to the authorities which is unlikely to be recovered, thereby restricting future options
- the staffing implications of CCT — redundancies, uncertainties, morale, lowering of wages, new work arrangements.

However, by late 1995 LGMB was aware of only just over 200 cases where problems have been sufficiently serious to warrant termination of the contract. Approximately two-thirds of termination involved external contractors. Nevertheless, in the late 1995 LGMB survey, 17 per cent of respondents marked external

contractor performance as unsatisfactory or very poor; only five per cent of DSOs were similarly marked.

7.6 The management of outsourcing

Despite the force of legislation behind outsourcing, there was still plenty of scope for different interpretations and approaches to CCT. Authorities still had to make decisions as to whether to submit an in-house bid. This consideration preceded a further set of decisions about which services, how much of the service, and in what style of package work should be put out to tender.

There were fears expressed that authorities would package tenders in a way that would strongly favour in-house staff. In reality there is little evidence of 'exotic' packaging, designed to frustrate a private sector bidder. Indeed the governments' own anti-competitive behaviour rules expressly forbid this and lay a duty on local authorities to foster a private sector market in order that bids might be obtained. Naturally, some authorities have been much more pro-active than others in positively encouraging the market to bid for work. One has sought the views of potential bidders whilst compiling specifications on their packaging and content. Others, whilst satisfying the government's requirements, have used a variety of strategies (management buy-outs and partnering arrangements with existing private sector operators) to protect staff and safeguard some of the council's core values and objectives which were perceived to be threatened by the CCT regime.

In order to be clear as to what the process and the rules would be in the context of an overall philosophy, one London borough established a central team to formulate an approach. The result is that directors of services are required to manage within a framework whose objectives are to:

- adopt mechanisms to safeguard the councils' interests
- develop strategies with the aim of increasing the quality of service
- determine packaging for high quality, value for money services
- introduce organisational arrangements to facilitate effective client roles
- prepare specifications which reflect the budget and emphasise the councils' public service ethos

- introduce arrangements that would allow in-house teams to bid
- protect staff terms and conditions so far as possible.

The same practical preparations as described more widely in section 6.2 apply to local government. There are, however, considerations which need to be made for outsourcing in the public sector which are either wholly absent from the private sector or are not to the same degree important. Creating a mechanism to divide a department into client and contractor roles can be complicated if there is to be a DSO bid, particularly given the statutory rules which apply. It is necessary to provide transparent trading practices if the internal bid is successful, otherwise 'foul' will be called by the disappointed external contractors. Also there are statutory minimum and maximum contract periods, which prevent local authorities taking a view on what sort of contractual relationship they seek.

7.7 Next steps

As we remarked earlier, there has been a growing acceptance by local authorities that outsourcing was an acceptable approach with some benefits to be realised through it, although there remained reservations about transferring work and staff to contractors which would not uphold the values espoused by councils. However, the spring of 1996 saw the provisions of the Local Government Act 1992 coming into effect with the first round of CCT covering 'white collar' activities. The government was disturbed to find less work being exposed to tender and won by private firms than had been anticipated. Based on accusations by external contractors of bias against them, the government set up a review under Sir Paul Beresford. His report in May 1996 proposed an increase in the percentage of work to be tendered under each function (*eg* for Finance this meant a rise from 35 to 65 per cent) and a lowering of exemption levels.

Local authorities were already concerned about the effects of CCT on certain of these functions (legal, finance, personnel, *etc.*) which they saw as strategically important. They were also worried, as before, about the market's capacity to respond with credible alternatives. And, as ever, many no doubt wanted to protect their own employees from being driven into contractor employment. Following the Beresford review, they now face tighter controls on their behaviour and reduced scope to avoid the externalisation of services.

Councils believe there is very little evidence of anti-competitor behaviour, or of the cheating and use of subterfuge to avoid CCT of which they are accused by the government. Indeed, there have only been one or two successful prosecutions for such offences and, according to the LGMB, well over 90 per cent of contracts have been awarded to the lowest bidder. However, the Housing Management Contractors Association was able to point to only 83 out of 208 contracts being exposed to competition in the first round of housing management contracts, and only five have been awarded to private contractors; DSOs have won 62 contracts. DSOs have been much less successful, however, in securing contracts for legal, and property and construction services.

Meanwhile, the continuing pressure to outsource a greater volume and type of work, is driving some authorities to regard themselves, willingly or not, as client commissioners and procurers of services rather than as 'providers'. This would mean a shift in their role to enabling and facilitating rather than doing. Yet, as in the private sector, there is still a need to define what core functions need to be retained for this task to be performed. Such activities as planning, audit, and standards are likely to be included in the list.

However, to a much greater extent than the private sector, the context in which these decisions will be made will be profoundly affected by those in power in central government. A change to a Labour government may give authorities more scope to be innovative in the way they approach service delivery. This could mean greater variety in the balance between internal and external provision, but also potentially greater control over the manner of contractor performance. As one authority manager put it: 'we can encourage firms to work for the council, adopt its values, be a caring employer with our staff properly looked after. We could lock it all up and sign a deal'. But whatever the mechanism, the pressure to hold down costs and push up quality will remain.

8. The Effect of Outsourcing on Employees

The biggest single HR issue that confronts employers when considering outsourcing is the legal rights of employees, particularly as defined under TUPE. These we will discuss below, but it should be noted that not all transfers have fallen within its terms. Some pre-date the legislation or its amended form, some have occurred on greenfield sites, and in other cases it has not been invoked, whether justifiably or not.

Large organisations, where the protection of a reputation as a responsible employer is important, have no doubt exercised great care to conform with the law, whilst at the same time managing the needs of the business. In companies of any size which are unionised, one imagines employee relations sensitivities have been an important consideration in affecting employer behaviour. Yet it has to be said that it is equally likely that smaller employers and less reputable contractors have either been ignorant of the law, or have sought to bypass its restrictions.

Quantitative evidence of what in practice has occurred is once again rather thin on the ground, and can be contradictory. This is demonstrated in the case of local government by an Equal Opportunities Commission study of the impact of CCT in 39 local authorities. It showed that in practice TUPE had not been applied in any of the nine cases where contracting out had occurred (IRS, June 1995). It pointed out that a combination of legally defensible redundancies, the hiring of new staff on lesser terms, and the non-renewal of temporary contracts had enabled contractors to change the workforce in the way that it wished. This picture contrasts with evidence from a Local Government Management Board survey in 1995 which found that 76 per cent of respondents used contracts containing a TUPE clause, and interview evidence that local authorities have sought to protect staff both in terms of security of employment and their conditions

of service. The EOC reported on the apparent contrast between expectation and reality by saying that:

> *'TUPE may not give the protection for jobs and terms and conditions that some of the managers and trade union officials contacted for the study, believed it offers'.* (IRS, June 1995).

It may be that in the future the way the transfer regulations will be applied will be more universal, as loopholes are filled and awareness is raised. This leads us to review the present legal position, but in the awareness that, through the development of case law, it is a frequently changing picture.

8.1 The impact of the legal position

After the EU members adopted the Business Transfers Directive (usually known as the Acquired Rights Directive) in 1977, in order to comply, the UK passed the Transfer of Undertakings (Protection of Employment) Regulations in 1981, often known as TUPE. In broad terms the principal effects of the Directive were to require:

- contracts of employment of the affected employees to be transferred automatically to the transferee with their terms and conditions of employment protected
- employers to inform and consult employee representatives of a proposed transfer of the whole or part of a business.

In fact TUPE did not conform precisely with the Directive and was amended in 1993 as part of the Trade Union Reform and Employment Rights Act (TURER) and again under the Collective Redundancies and Transfer of Undertakings (Protection of Employment) (Amendment) Regulations in 1995.

The first amendment was to allow non-commercial transfers to be included under the terms of TUPE. Presumably the Conservative government had wished to limit the scope of the legislation so as not to hinder the progress of the competitive tendering initiative in the public sector. The latest amendment concerns the requirement to inform, and in some situations consult, employee representatives, even where trade unions are not recognised (this is discussed in section 8.1.4). The Act also made plain (after a controversial EAT ruling in the case of Milligan v

Securicor Cleaning Ltd) that the two-year service qualifying period would apply in complaints brought under TUPE.

Understanding the relationship between TUPE (TUPER) and the Directive is important because of the way the courts interpret the legislation. Naturally, the European Court of Justice (ECJ) looks to the Directive as its source, but even the UK courts have an obligation to interpret TUPE with the original Directive in mind. This position was explained by the EAT in an analogous case (Webb v EMO Air Cargo (UK) Ltd), by saying that tribunals should construe TUPE *'so as to accord with the interpretation of the Directive as laid down by the ECJ if that can be done without distorting its meaning'*. And it is taken that the principal objective of the Directive, which the courts should aim to promote, is the protection of the employee's right to remain in employment on transfer and to continue to enjoy the same terms and conditions.

It may appear that the purpose of the Directive is wholly in favour of employees. However, its requirement that employees follow their work to the transferee denies them their common law right in the UK to choose their employer. As we will see later, there are circumstances where the employee can opt out, but, nevertheless, there is a denial of previous rights. Whilst there are clearly advantages to employees to offset this loss, there are similarly pros and cons from the employers' perspective. The most important benefits to the latter are that continuity of knowledge and expertise can be ensured across the transfer (especially important in outsourcing) and a lot of the heat can be taken out of discussions with employees over terms and conditions because the major issues are settled in advance. As one manager put it, *'it removes the major source of friction between management and unions'*.

We will now look at the key provisions of the legislation.

8.1.1 What is a transfer?

In the Directive any *'transfer of undertaking, business or part of a business to another employer as a result of a legal transfer or merger'* falls under its terms. Over the years, through the judgements of the ECJ, the definition of a 'legal transfer' has been broadened so that where there is a change in the person responsible for the employment function then a transfer has occurred. Thus it does not cover the sale of a firm by the transfer of shares because the employer remains unchanged. Besides the need to establish

whether a 'legal transfer' has taken place, there is also the requirement that an identifiable 'economic entity' is transferred. This means that the entity must retain its identity by carrying out essentially the same tasks after as before. As recently as October 1995, the ECJ further refined this position to require that the undertaking transferred must be 'stable' and 'capable of continuation', *ie* that a temporary task is not involved.

Using this definition, transfers are covered even where the entity itself does not transfer nor any physical assets, but only the service provision is involved. This allows the full range of outsourcing situations to be included. Thus where only the management of the activity is passed to the contractor the law can be invoked. This was made clear in a 1993 ECJ ruling in the contracting out by Philips of one of its canteens to ISS Kantineservice. Moreover, even if the control of the services remains with the client, if the contractor takes over its day to day operation and the employment responsibilities, then a transfer has occurred (see for example Kelman v (1) Care Contract Services Ltd v (2) Grampian Regional Council in 1993). Also, as the more famous 1994 'Schmidt' judgement revealed, it only requires one person (a cleaner in this case) to be involved for a relevant transfer to have been effected.

Importantly for CCT, it is also now clear that transfers can apply over more than one phase, so that the transfer of an activity from one contractor to another is covered. This was established in the Dines case in 1994 where hospital cleaning services were contracted out first to Initial Health Care and then to Pall Mall. The key test was again that of 'retained identity' not the frequency of contract awards. Similarly, insourcing arrangements are included, as shown for example where the Isles of Scilly Council retook responsibility of certain airport services from a contractor.

These judgements led the Industrial Relations Law Bulletin to write that *'it is increasingly difficult to conceive of circumstances in which contracting out, or a change in service provider, will not be covered by TUPE'* (February, 1995). In fact the interpretation that the entity must retain its identity does mean that some transfers are excluded where the business is transformed. This was shown in (1) Mathieson (2) Cheyne v United News Shops Ltd in 1994, where United News Shops took over a hospital shop and turned it into a commercial venture with different opening hours and a new range of goods. However, such a change has to take

place at the moment of transfer; it cannot be put into effect at a later date and at that point claim that the law does not apply.

8.1.2 Selection and restructuring

If TUPE applies, then there is very limited choice as to who must transfer. In most cases it should be obvious. Those staff who are working in the relevant part of the enterprise at the time of the transfer are required to change employer. However, this is not always so clear cut, particularly if there are employees whose activities include both work which is transferring and that which is remaining. In these circumstances the employer will probably have to establish some criteria on which to make the decision as to whether the employee stays or goes. In other cases reference may need to be made to the contract of employment and what it specifies. Alternatively, the facts on the ground, where the employee is currently assigned, may be critical.

Some organisations wish to be as black and white as possible and remove ambiguities. Thus they take a hard line and insist that everyone involved must transfer without the option of re-assignment or voluntary redundancy. Others have taken the opposite approach and have tried to take account, to some extent at least, of employee wishes for an alternative job or severance. Indeed, British Gas, in an outsourcing deal with Hoskyns (IDS, 1995), offered employees the choice of voluntary redundancy, redeployment or transfer. Six hundred out of 1,150 eligible staff opted for Hoskyns. It is also possible legally for an employee to be re-assigned within the firm at the company's instigation at the time of the transfer so to avoid its effects if s/he has a flexible job description or contract. Naturally this is made much easier if the employee agrees to the move. But this may cause conflict with the contractor if the client seeks to keep all its best employees and prevent their transfer.

Without intervention from the employer, the contract automatically transfers. If the employee is unhappy with this the only recourse is to claim constructive dismissal by arguing that there is a substantive alteration to their 'working conditions' which breaks the contract or that the change of employer is 'significant' and to his/her 'detriment'. These rights should be the same as those that apply in situations other than transfers, *ie* under the Employment Rights Act of 1996. If s/he cannot prove this detrimental impact, there is the opportunity introduced via

TURER to object and have his/her contract terminated by the transferee without any right to compensation.

If the employee is severely restricted in avoiding the impact of TUPE, employers are even more constrained if they wish to reshape their workforce through downsizing. All dismissals are automatically unfair if they are connected to the transfer, unless the employer can justify the decision on economic, technical or organisational grounds (the so-called ETO defence). This applies whoever is their employer, transferor or transferee, wherever the employees are employed — in the part of the enterprise which is subject to the deal or not — and whether before or after the transfer. The Litster case of 1989 showed that employers cannot escape the purpose of this legislation by dismissing employees before the transfer takes place so that they can be re-engaged on poorer terms by the contractor. Nor can the contractor get round its provisions by sacking part of the workforce as soon as they have acquired them. Although in the case of the transferee, the longer they leave the decision the easier it will be to suggest that it is not connected to the transfer. However, for the transferor it will be harder to persuade the courts that there is not collusion between the parties to evade the law.

There is also the ETO defence. The courts have found the wording taken straight from the Directive rather difficult to interpret and have tended as a consequence to be rather conservative in their judgements. So the employer will probably have to show the dismissals are necessary rather than merely desirable to ensure the well being of the firm, and that they are designed to alter overall numbers and functions of employees, not just be an incidental effect. The employer cannot justify redundancies on the basis that it improves the terms of a sale or transfer, but they may be able to prove that they are essential for the future success of the enterprise. And this is much easier for the transferee to sustain than the transferor.

During the time of the transfer, employers can still dismiss on grounds of conduct or capability, but great care would need to be exercised because the courts are likely to be suspicious of employer motives during this period. And in all such cases of dismissal, the usual test of the reasonable behaviour by the employer applies, and if it is a redundancy, that a 'fair selection' has operated.

Another point to note is that, based on a recent EAT judgement, the transfer does not take place until the employee is informed of the transfer and its nature. Until the employee knows who is his/her employer will be s/he remains employed by the present employer.

8.1.3 Terms and conditions

All *'rights, powers, duties and liabilities'* in connection with the employment contract, as TUPE puts it, pass wholly to the contractor. This means that they must honour all terms and conditions of employment, and deal with any outstanding claims, such as under sex discrimination or breach of contract. The contractor must also accept any agreements or commitments entered into with trade unions prior to the transfer. However, if the latter are only 'gentlemen's agreements' (which most are in the UK) they are not legally enforceable until incorporated into contracts of employment (which are covered anyway). Thus the contractor could choose to ignore them.

The one area expressly excluded from the transfer rules is membership of an occupational pension scheme. Although subject to various legal interpretation (most recently in Adams v Lancashire County Council), the current view is that whilst pension benefits do not automatically transfer, accrued rights are protected. Thus rights derived from continuity of employment are preserved, even if there is a break between the two periods of employment so long as this is part of the 'machinery' of the transfer. Under other legislation, the right to a deferred pension after two years' membership in a scheme is also protected.

The Department of the Environment advises contractors to provide 'mirror image' pension schemes for transferees. These are intended, according to the DoE, to provide 'broadly comparable' pension benefits. This phrase is naturally open to wide interpretation and the full equivalent of an index-linked, guaranteed pension may well not be offered. Nevertheless, the LGMB survey, referred to earlier, found that only 58 per cent of respondents insisted that comparable pensions should be provided to those transferring to contractor employment. Some private sector companies go beyond what is legally required concerning pensions. TSB, for example, enhanced the transfer value of transferring staff's pensions by estimating the value of past service, as if the staff had remained in service with the

bank until normal retirement. British Gas, in a shorter outsourcing deal, kept their ex-employees in their pensions scheme until it was clear whether Hoskyns would offer them further employment (IDS, 1995).

Nevertheless, at the margin it is not always clear what falls within the scope of this legislation. There have been particular questions regarding share option schemes that centre around its precise details. There are also problems (again with share option, profit sharing schemes or unique contractual terms) which are hard if not impossible to transfer. In this case the transferee can offer equivalent terms. This may still be impractical if it in effect requires running a separate payroll for a small group. Putting the value on some terms and conditions is nigh on impossible. For example, how do you calculate the effect of a change in payroll date, or value mortgage assistance?

Whilst it is possible to make a current estimation, it is the long term worth of the benefits that is problematical. This makes the option of a buy-out much more attractive, since it is cleaner and simpler. To illustrate the dilemma: TSB employees moving to computer contractor Sema were offered in place of their existing profit sharing scheme, the choice of an annual allowance for five years (the length of the contract) based on the average value of the scheme over the previous five years, or a cash sum paid in five instalments, though this also took account of other benefits (IDS, 1995).

However, the key to this process has always been to secure employee agreement to any offer. To date, there have been numerous examples in the UK of employees freely agreeing to variations on their terms and conditions on transfer or even to choose to avoid its effects, *eg* by taking redundancy prior to transfer and engagement afterwards on new, even worse, conditions. In the British Gas example, those who moved to Hoskyns were made redundant first, but this was to ensure equal access to an early pension on the same terms as those staff staying. The courts do not seem to have objected. However, in a recent case of Wilson v St Helens Borough Council, the EAT stated that an employee was not legally capable of agreeing to a detriment to his terms and conditions as result of a transfer, because these were protected at law. It has always been understood that during the transfer process neither transferee nor transferor could write in terms which denied employees their rights. This included making a financial settlement with an

employee not to pursue a claim based on these rights. But it seems now that even freely given consent may not be sufficient protection for employers to avoid possible legal action. What is difficult for employers if this case stands (it is subject to an appeal), is that the sort of deals described above stand outside the law and are not enforceable. This means proceedings can be initiated by a disgruntled employee some time after the agreement has been made if s/he objects to any detrimental effect, however small. In practice, will this mean that employers will continue to seek agreement to the terms of a settlement and hope that there will not be a subsequent comeback? What is certain is that employers will have to be doubly sure that if they propose a compromise agreement, where one benefit is exchanged for another, that employees fully understand and agree to the deal.

In this process, an understandable objective of contractors may be to harmonise terms and conditions between the transferring employees and their existing workforce. Clearly this not a problem if the terms are at least as good as previously enjoyed. With the major IT contracts this may well be the case, but not with respect to ancillary services. If new terms are imposed by the transferee, any dismissal of an employee adversely affected who refuses to accept the changes, is automatically unfair. Similarly, if s/he resigns for this reason, a claim of unfair dismissal can be brought. Following the 1985 Berriman v Delabole Slate Ltd decision, pay standardisation alone is unlikely to succeed as an acceptable ETO reason for dismissal.

Since the contractor must in theory honour the existing terms and conditions in perpetuity, only gradually will their value fall, as they are frozen at their existing level. Although there must come a point where the employer can claim that the changes are not connected with the transfer, it will be hard to substantiate this if only the transferees are affected. Certainly the situation may become very complicated if there are various categories of employee on different terms and conditions. This may be manageable if there are small numbers of transferees on their old pay rates who can be 'red-circled'. It becomes more problematical if there is pressure to harmonise from either new or existing employees, where their representatives seek to apply the highest common denominator.

Making comparisons between sets of terms and conditions can occur between various groups: within the transferee's workforce

as above, or between those who stayed with the client and those who left. Here the revised and previous remuneration may be compared with the same aim to harmonise upwards.

Rather surprisingly, the contractor has more scope with respect to changing employee terms where they are connected to a change of job content. Consent of the employees to any changes must always be sought. However, if there is a dispute which comes to court through a dismissal, because consent was not obtained, or if there is a claim of constructive dismissal, it seems that contractors can successfully use the ETO defence if they make fundamental changes to job functions of their workforce. As we have seen, harmonisation of pay on its own is not going to be a sufficient cause.

8.1.4 Information and consultation

Following the ECJ judgement that UK law did not provide means for those who were not covered by trade union agreements to be informed and consulted over business transfers, TUPE was amended in 1995 and new provisions came into effect on 1st March 1996.

Employers of any size who are involved in a transfer of undertaking are obliged to inform and, in certain circumstances (defined below), consult 'appropriate representatives' of 'affected' employees. The 'appropriate representatives' can be union representatives, where the union is recognised for bargaining purposes, or they can be employees elected by their colleagues, either specifically for this purpose or not. No method of election is specified and *ad hoc* arrangements are acceptable. If there are both types of representatives covering the same affected employee group, the employer can choose whom to consult.

Where representative structures do not exist, in order that representation is arranged the government appears to envisage the employer 'inviting' staff to elect representatives as and when required. Failure of employees to respond would seem to absolve the employer of any further duties, but they must be given the opportunity to hold elections. However, despite the benefit of extra legal advice from the Department for Trade and Industry, the whole area of employee election and invitation is rather vague and likely to be subject to much interpretation by the courts.

To allow employees to be informed effectively, the employer must provide employee representatives with sufficient information 'long enough' before the transfer to enable them to carry out their duties. However, the law does recognise that there may be 'special circumstances' which may influence an employer's ability to meet their obligations. Under the Regulations the employer must formally inform representatives of:

- the fact of the transfer
- its approximate timing
- the reasons for it
- legal, economic and social implications of the transfer for 'affected employees'
- the 'measures', if any, the transferor 'envisages' they will take in connection with the transfer
- the measures, if any, the transferee envisages they will take in connection with the transfer, for those who will become their employees as a result of the transfer.

This means that either the transferring employer, or the transferee, must inform employee representatives of the implications of the transfer, if any employee, even a single one, may in any way be affected by it. This specifically includes any 'measures' (*ie* 'action, step or arrangement') either party 'envisages' (*ie* visualises or foresees as part of a plan or proposal) taking.

If the employer does indeed envisage that they will be taking measures as a result of the transfer, then there is a further duty to consult as well as inform. Consultation with employee representatives must be: *'with a view to seeking their agreement to measures to be taken'*. Thus employers are expected to enter meaningful discussions, both with respect to their timing and content. They should allow representatives to respond and any proposals made should be considered. However, in the final analysis there is no duty to agree. If the measures include collective redundancies then there is also a duty to inform and consult under the terms of the relevant legislation — terms which are subtly different from those for business transfers.

Those employees standing for election and those selected as representatives are given the sort of rights and protection usually afforded to trade union representatives; that is not to suffer any 'detriment' by virtue of his/her duties and to have reasonable

paid time off, and access to affected employees to perform his/her activities.

8.2 Employee development

For transferring employees there may be advantages in moving to the contractor's employ. These may derive from being employed in core rather than service function — *'on the revenue side rather than the cost side of the equation'* (Labbs, 1993); from the wider opportunities this may bring for career advancement or development; from the greater range of work location and tasks in a more satisfying environment. These benefits are more likely to be found in the high skill end of the market, not least because the issue of terms and conditions is not so problematical. By comparison, whilst the same principles may apply at the lower skill end, if an employee has transferred on his/her existing pay it means that to progress within the contractor's organisation s/he may have to suffer a reduction in wages. This is more likely to happen in ancillary service transfers because of the delta between client and contractor remuneration. So for example, a sous chef to move to head chef might have to take a drop in wages. And, since this market is very cost sensitive, the opportunities for training may more restricted in the client's employ. The contractor will always be pleased to improve the skills of his staff, but generally only where this is paid for by the client. Otherwise training may only amount to induction and any mandatory requirements. Meanwhile, the pressure to perform within a tight cost environment is likely to mean harder work and a tougher regime than previously experienced.

In situations where work is subject to frequent, repeat tendering, as in CCT, there is also the added dimension of employment, let alone career, insecurity. Not only may staffing reductions occur over time to meet price requirements, but also there is the worry about winning the contract again the next time.

Other problems can occur once the transfer has taken place for those that remain. They may lose traditional career paths. For example, if mainframe computing is outsourced it may remove traditional development slots for systems engineers. As a result, the employer may suffer retention problems, particularly if there is a perception that those who moved did better out of the transfer. Again this is a difficulty to be found more often amongst the more skilled population.

9. The Future for Outsourcing

What will the key developments be in outsourcing over the coming years? Are the easy bits of outsourcing already done? In other words, has it reached its peak or will it continue to grow? If there is growth, will it mean denser coverage of the same areas as now, or will new sectors be involved?

Will there be a change in the nature of outsourcing, away from cost as the primary driver to service, and simultaneously from antagonistic to co-operative relationships? Is there really a move to strategic partnerships?

Will there be a tendency towards insourcing rather than outsourcing? Will there be greater variation in the way tasks are carried out, such that arrangements will be more complex than a simple dichotomy between internal and external sourcing?

Naturally it is hard to say precisely what the future trends will be. However, some of the key influences on decision making are clearer.

9.1 External environment

9.1.1 Change of government

If a Labour government is elected there are some practical changes we can expect to see, as well as a more general alteration in the climate within which business operates:

- a switch from CCT to performance targets in the public sector. To ensure value for money for customers, these measures may stipulate expected year on year service improvements, but leave councils free to decide their methods.

- the introduction of the minimum wage restricting the scope of contractors to cut payroll costs. Key issues are at what level it will be set and how it will be enforced.
- greater acceptance of EU regulation under the Acquired Rights Directive. Whether there will be an attempt to clarify what is covered by TUPE such that it is more straightforward and therefore easier to operate is uncertain. Probably any change of this sort would come directly from the European Commission.
- greater regulation of the terms and conditions of employment of employees on atypical contracts.
- greater regulation of contractors in certain sectors to meet minimum standards, which is likely to mean that the big sophisticated service providers will flourish at the expense of the cowboy operations.
- strengthened rights for trade unions to obtain bargaining agreements with employers if they can demonstrate sufficient membership and support.

9.1.2 European impact

This may come from two directions, from legislation by the EU itself, or from the interpretation of existing law by the European courts, especially the European Court of Justice. It seems unlikely that in the immediate future there will be fresh legislation covering employee transfers which radically transforms the position. A proposed amendment to the Acquired Rights Directive made by the Commission dating from 1994 is largely a tidying up exercise which does not extend employee rights, *eg* to pension protection. This is because of late the Commission has been more interested in improving economic performance to reduce unemployment, than to further employee rights. Most EU governments have been in the same position.

In more detail the proposals are:

- to provide a codification of what constitutes a transfer
- to restrict coverage, where only an activity of an undertaking transfers, to those where they are part of an economic enti which retains its identity
- to make clear that the Directive applies to public or private entities whether operated for gain or not

- to allow Member States to exclude the provisions from certain situations of rescue from bankruptcy
- similarly to allow employee terms and conditions to be changed where the survival of the business is in doubt
- within certain limitations to allow Member States to decide who is an 'employee' under the terms of the Directive
- to harmonise definition of workers' representatives and to preserve their status and function more than at present
- to make the transferor and transferee jointly liable for the rights and obligations of employees so long as the transferor's liability is limited to those which occur in the first year after transfer
- to prevent multi-establishment organisations from avoiding the requirement to inform and consult by claiming that the enterprise in question was not involved in the transfer decision
- to allow Member States to introduce minimum workforce thresholds before there is a requirement to inform and consult.

A number of these changes would have a limited impact. The first three are already in effect covered by case law. For the rest there is a balance of advantage and disadvantage from the employer or employee perspective. Trade unions would no doubt welcome greater protection than at present. Currently, the continuity of their rights only applies whilst the transferred undertaking maintains itself distinct from the rest of the transferee's organisation. Employers might benefit from greater flexibility in a corporate rescue operation. Contractors might welcome the sharing of liability with clients.

The courts by contrast have been active and have, as we have seen, had quite a profound affect on domestic regulation, both in changing primary legislation and affecting its interpretation. This is likely to continue, albeit perhaps with no more major shocks, certainly as UK practice fulfils the spirit as well as the letter of the law.

9.1.3 Pressures on employers

There is unlikely to be any let up in the pressures to reduce costs and maximise productivity in a fast changing, competitive environment. This will mean that ways of doing business and working practices will constantly be examined. It will result in continuing changes in organisational structure and employee

deployment, as well as acquisition and disposal of activities or companies.

Organisations will not, however, be working in either the climate of the late 1980s boom or of the early 1990s recession. If there is a change of government there will be no political encouragement towards outsourcing. One senses too something of a revolt against the philosophical championing of outsourcing once found in the management literature. This is partly because problems with outsourcing have occurred and have been highlighted, thereby causing some to wonder whether market determined solutions are always so appropriate. This links to the concern that the exclusive emphasis on rational, cost-based decision making neglects the softer issues of culture and employee motivation which are also seen as important in deriving competitive advantage.

In fact, employers face a number of paradoxes: they outsource in order to save money, yet are worried about being exploited on cost. They outsource to improve service, but they fear that it may deteriorate. They choose to contract out to avoid the hassle of management, yet they still need to control. Some companies, as reported earlier, will not be concerned with these issues; they would argue for strategic outsourcing by retaining only core tasks. Others who see it as a tactical question will make their judgements on an activity by activity basis, being careful not to damage their vital interests. They are likely to be sympathetic to the view that a simple core/periphery model is not without its problems. It is not always self evident or easy to analyse. Who would think of the payroll system as a core task which confers competitive advantage? This is what a US security firm found in attracting good quality guards, because the company had a reputation for on-time and accurate payment of wages (Lacity, 1996). Moreover, what constitutes the core changes? For example, automatic telling machines were once a source of competitive advantage to Citibank but are now standard practice (Lacity, 1996). Who the core workers are, and their skills, may also change, say through technological developments, as in the move away from big mainframe IT systems. Moreover, non-core activities may significantly impact the core indirectly. Thus issues of integration and synergy are important.

The other approach which has increasingly come into vogue is that of the *strategic alliance*. This aims for a win/win arrangement where both parties benefit. From the client's perspective it seeks

to minimise Williamson's concern over opportunism by locking the contractor into a deal, but also satisfies contractor fears by also binding the client. Despite the reservations of some (quoted in Chapter 4) this type of arrangement is likely to prosper in high technology situations, but has also been the basis of Marks and Spencer's approach to supply contracts (Sisson, 1995).

9.2 Conclusions

At the risk of over simplification, the following are some possible developments:

For clients:

- There will always be a balance struck between cost and service — it is never going to be one to the exclusion of the other, particularly as the drive to keep down costs and improve quality production will persist.
- Clients will continue to be more sophisticated and demanding in what they expect from contractors and in how they manage them.
- They are also likely to be more cautious in how they proceed. They may have learnt from the past that you cannot outsource problems, that you need to be certain that the contractor can do the job better than you, and that you have to retain the capacity to manage an activity once it is outsourced.
- This means defending the brand, retaining core skills and protecting intellectual property rights. This may inhibit going beyond the low skill, easily purchasable and clearly peripheral activities.
- Care will be necessary with internal employee relations issues and external reputation. This means handling an ever more complex legislative situation and protecting interests, even when operational responsibility has passed to a third party.
- This suggests partial and selective outsourcing by those who already have contracted out the obvious services. One result may be greater diversity of arrangements, combining internal and external service provision. This suggests that there will be more mixing of own and agency staff before full outsourcing is considered. Alternatively, competition between in-house and contractor services may be more encouraged. This would occur at both ends of the skill spectrum.

- This implies wider outsourcing of the already popular (*ie* ancillary services) and of related work (*eg* porterage together with mail room) by those organisations and sectors where it is not yet common. Financial activities according to some observers is the next obvious area to be contracted out, as more and more services are standardised and automated (Rock, 1995 and *British Journal of Administrative Management*, 1995).

- Clients will give increasing attention to the broad range of managerial skills and mind-set required to manage contracts, as evidenced by the new BFM qualification.

For contractors:

- There is a likelihood of continuing pressure to deliver cost effective service in an increasingly competitive and regulated environment.

- Increased volatility in the market can be expected as clients are much more prepared to change contractors when there are problems. This means greater effort will be required to secure and retain contracts as customer loyalty will be purely instrumentally based.

- Accepting more risk sharing, and consequently reward sharing.

- A growing requirement to offer well trained and motivated staff, thereby putting higher premium on continuity of employment.

- Placing greater emphasis than previously on cultural fit if a contract is to work successfully.

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